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American Institute of Certified Public Accountants. Banking and Savings Institutions Committee

AICPA
AUDIT AND
ACCOUNTING
GUIDE

Banks and Savings Institutions

New Edition as of April 1, 1996

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Certified Public Accountants

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BANKS AND SAVINGS INSTITUTIONS

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Certified Public Accountants

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NOTICE TO READERS

This AICPA Audit and Accounting Guide has been prepared by the AICPA Banking and Savings Institutions Committee to assist preparers of financial statements in preparing financial statements in conformity with generally accepted accounting principles and to assist auditors in auditing and reporting on such financial statements in accordance with generally accepted auditing standards.

Descriptions of accounting principles and financial reporting practices in Audit and Accounting Guides are approved by the affirmative vote of at least two-thirds of the members of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report,* identifies AICPA Audit and Accounting Guides that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. This Audit and Accounting Guide has been cleared by the Financial Accounting Standards Board. AICPA members should consider the accounting principles described in this Audit and Accounting Guide if the accounting treatment of a transaction or event is not specified by a pronouncement covered by rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatments specified by this Audit and Accounting Guide should be used, or the member should be prepared to justify another treatment, as discussed in paragraph 7 of SAS No. 69.

The AICPA Auditing Standards Board has found the descriptions of auditing standards, procedures, and practices in this Audit and Accounting Guide to be consistent with existing standards covered by rule 202 of the AICPA Code of Professional Conduct. Descriptions of auditing standards, procedures, and practices in Audit and Accounting Guides are not as authoritative as pronouncements of the Auditing Standards Board, but AICPA members should be aware that they may have to justify a departure from such descriptions if the quality of their work is questioned.

G. Michael Crooch, *Chair*
Accounting Standards Executive Committee

Edmund R. Noonan, *Chair*
Auditing Standards Board

Banking and Savings Institutions Committee (1995-1996)

The committee and staff also gratefully acknowledge the contributions of Richard L. Brezovec, Gary W. Brummett, Stephen R. Herbert, Roger H.D. Molvar, and Stephen P. Theobald.

In developing this Audit and Accounting Guide, the AICPA Banking and Savings Institutions Committee considered guidance included in the following authoritative pronouncements:

- FASB Statements through Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*
- FASB Interpretations through Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*
- FASB Technical Bulletins through Technical Bulletin No. 94-1, *Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring*
- AICPA Statements of Position (SOP) through SOP 95-4, *Letters for State Insurance Regulators to Comply With the NAIC Model Audit Rule*
- AICPA Practice Bulletins (PB) through PB 14, *Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships*
- Issues considered by the FASB's Emerging Issues Task Force (EITF) through EITF Issue No. 95-11, *Accounting for Derivative Instruments Containing both a Written Option-Based Component and a Forward-Based Component*
- AICPA Statements on Auditing Standards (SAS) through SAS No. 79, *Amendment to Statement on Auditing Standards No. 58*, Reports on Audited Financial Statements [Note: SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An amendment to SAS No. 55*, is effective for audits of financial statements for periods beginning on or after January 1, 1997. Future editions of this Guide will incorporate conforming changes necessitated by SAS No. 78.]
- AICPA Statements on Standards for Attestation Engagements (SSAE) through SSAE No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2* [Note: SSAE No. 6 is effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996 or thereafter. Future editions of this Guide will incorporate conforming changes necessitated by SSAE No. 6.]

Users of this Guide should consider pronouncements issued subsequent to those listed above to determine their effect on entities covered by this Guide.

Preface

Purpose

P-1. This American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide has been prepared to assist banks and savings institutions in preparing financial statements in conformity with generally accepted accounting principles (GAAP) and to assist independent accountants in reporting on financial statements (and, as discussed in appendix D, other written management assertions) of those entities.

P-2. Chapters of the Guide are generally organized by financial statement line item into four sections:

a. An *Introduction* that describes the general transactions and risks associated with the audit area. (The introduction does not address all possible transactions in each area.)

b. *Regulatory Matters* that may be of relevance in the audit of financial statements. Other regulatory matters may exist that require attention in the audit of financial statements following the general guidance on regulatory matters discussed in chapter 2. Further, the Guide does not address regulations that are not relevant to the audit of financial statements and certain of the regulatory requirements discussed may not be applicable to uninsured institutions.

c. *Accounting and Financial Reporting* guidance that addresses accounting and financial reporting issues (Statement on Auditing Standards [SAS] No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* [AICPA, *Professional Standards*, vol. 1, AU sec. 411], establishes the hierarchy of GAAP).[1]

d. *Auditing* guidance that includes objectives, planning, the internal control structure over financial reporting and possible tests of controls, and substantive tests.[2]

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[1] Footnote 3 to SAS No. 69 states, in part, that, for Securities and Exchange Commission (SEC) registrants, rules and releases of the SEC have an authority similar to other officially established accounting principles. For example, Article 9 of Regulation S-X specifies the form and content of and requirements for financial statements filed with the SEC by bank holding companies. Similarly, bank holding companies disclose supplemental statistical disclosures in filings following the guidance of Industry Guide 3, *Statistical Disclosures by Bank Holding Companies*. SEC Staff Accounting Bulletin (SAB) No. 69, *Application of Article 9,* includes the SEC staff view that Article 9 and Industry Guide 3, "while applying literally only to bank holding companies, provide useful guidance to certain other SEC registrants, including savings and loan holding companies, on certain disclosures relevant to an understanding of the registrant's operations." Those rules and interpretive releases, including SEC SABs, are not presented in the Guide; however, readers should consult the applicable requirements as necessary.

[2] In December 1995, the Auditing Standards Board (ASB) issued SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). SAS No. 78 revises the definition and description of internal control contained in the SASs to recognize the definition and description contained in *Internal Control—Integrated Framework* published by the Committee of Sponsoring Organizations of the Treadway Commission. SAS No. 78 is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted.

In conjunction with SAS No. 78, the ASB issued Statement on Standards for Attestation Engagements (SSAE) No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2* (AICPA, *Professional Standards*, vol. 1, AT sec. 400). SSAE No. 6 conforms the description of elements of an entity's internal control to the components of internal control contained in SAS No. 78 and the *Internal Control—Integrated Framework*. SSAE No. 6 is effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, with earlier application permitted.

Applicability

P-3. This Guide applies to preparation and audit of financial statements of entities regulated by the federal banking regulatory agencies.[3] That population includes—

- Depository institutions insured by the FDIC's Bank Insurance Fund (BIF) or Savings Association Insurance Fund (SAIF), whatever the institution's charter.
- Bank holding companies.
- Savings and loan association holding companies.
- Branches and agencies of foreign banks.

P-4. The Guide also applies to preparation and audit of financial statements of:

a. State-chartered banks and savings institutions not insured by the FDIC's BIF or SAIF.

b. Foreign banks to the extent those financial statements are purported to be prepared in conformity with accounting principles (or audited in accordance with auditing standards) generally accepted in the United States.

P-5. As used in this Guide, the term "banking" includes the activities of all banks and savings institutions regardless of charter. Also for purposes of this Guide, the term "depository institutions" means banks and savings institutions but not credit unions (which are the subject of the AICPA Audit and Accounting Guide *Audits of Credit Unions).*

Limitations

P-6. The Guide is intended to highlight significant matters and establish general guidance. It is not intended to provide comprehensive discussion of all possible matters of significance in an audit of financial statements or all audit situations that an independent accountant might encounter in an audit of the financial statements of a bank or savings institution.

P-7. Consulting the accounting and financial reporting and auditing sections of the Guide cannot take the place of a careful reading of specified authoritative literature. Other professional literature and authoritative guidance that may be issued by the Accounting Standards Executive Committee (AcSEC), the Financial Accounting Standards Board (FASB), including its Emerging Issues Task Force (EITF), or the ASB may affect audits of the financial statements of banks and savings institutions.[4] Further, the nature,

[3] The federal banking regulatory agencies are the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

[4] At the date of publication of the Guide, the latest authoritative pronouncements issued included FASB Statement of Financial Accounting Standards No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations;* SAS No. 79, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements; SSAE No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2*; AICPA Statement of Position (SOP) 95-3, *Accounting for Certain Distribution Costs of Investment Companies*; AICPA SOP 95-4, *Letters for State Insurance Regulators to Comply With the NAIC Model Audit Rule;* EITF Issue No. 95-11, *Accounting for Derivative Instruments Containing both a Written Option-Based Component and a Forward-Based Component;* and Practice Bulletin 14, *Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships.*

Also, in October 1995, the FASB issued a proposed Statement, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* The proposed Statement would significantly affect accounting for (including disclosures about) securitizations, sales of partial inter-

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timing, and extent of audit procedures applied in a financial statement audit is ultimately determined by the independent accountant in the circumstances. The procedures discussed in the auditing section of the Guide are not intended to be comprehensive and, performed by themselves, would not necessarily constitute an audit in accordance with generally accepted auditing standards (GAAS). Nor would omission of certain procedures set forth in the Guide necessarily result in a violation of GAAS. The internal control structure over financial reporting and possible tests of controls are discussed in the context of a financial statement audit. While they may correspond to internal controls that are the subject of procedures performed in an engagement performed in accordance with SSAEs, the internal control structure over financial reporting and possible tests of controls are not presented in that context and are not intended to address the considerations of such an engagement.

Impact on Other Literature

P-8. This Guide supersedes the AICPA Audit and Accounting Guide *Audits of Savings Institutions* and the AICPA Industry Audit Guide *Audits of Banks.* Appendix D provides guidance on certain engagements performed by independent accountants in accordance with SSAEs that might also be requested by banks and savings institutions.

P-9. The Guide supersedes SOP 83-1, *Reporting by Banks of Investment Securities Gains or Losses.* The Guide incorporates and supersedes SOP 90-3, *Definition of the Term* Substantially the Same *for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position,* to the extent SOP 90-3 amended previous editions of the AICPA Audit and Accounting Guide *Audits of Savings Institutions* and the AICPA Industry Audit Guide *Audits of Banks.* The Guide incorporates and supersedes the following SOPs:

a. SOP 90-5, *Inquiries of Representatives of Financial Institution Regulatory Agencies*

b. SOP 90-6, *Directors' Examinations of Banks*

c. SOP 90-11, *Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets*

P-10. The Guide supersedes Exhibits C, D, and E of Practice Bulletin 1, *Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance,* and incorporates and supersedes Exhibits G and H of Practice Bulletin 1.

P-11. The Guide incorporates the AICPA Auditing Procedure Study *Auditing the Allowance for Credit Losses of Banks.*

Effective Date and Transition

P-12. For accounting and financial reporting provisions of this Guide that describe other authoritative literature, effective dates should be applied as provided for in the related literature. All other accounting and financial report-

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(footnote continued)

ests, servicing assets and liabilities, securities lending transactions, repurchase agreements, "wash sales," loan syndications and participations, risk participations in banker's acceptances, factoring arrangements, transfers of receivables with recourse, and extinguishments of liabilities. Comments on the proposed Statement were due in January 1996. Readers should be alert to any final pronouncement.

ing provisions of the Guide, including disclosures about regulatory matters, shall be effective for financial statements issued for fiscal years ending after June 15, 1996, and for interim financial statements issued after initial application. The auditing provisions of this Guide shall be applied prospectively to audits of depository institutions' financial statements for fiscal years ending after June 15, 1996. Earlier application of the accounting, financial reporting, and auditing provisions of this Guide is permitted but not required.

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Chapter 1
Industry Overview

Business Purpose

1.01 Banks and savings institutions provide a link between entities that have capital and entities that need capital. They accept deposits from entities with idle funds and lend to entities with investment or spending needs. This process of financial intermediation benefits the economy by increasing the supply of money available for investment and spending. It also provides an efficient means for payment and transfer of funds between entities.

1.02 Government, at both the federal and state levels, has long recognized the importance of financial intermediation by offering banks and savings institutions special privileges and protections. These incentives—such as credit through the Federal Reserve System and federal insurance of deposits—have not been similarly extended to commercial enterprises. Accordingly, the benefits and responsibilities associated with their public role as financial intermediaries have brought banks and savings institutions under significant governmental oversight. Federal and state regulations affect every aspect of banks and savings institutions' operations. Similarly, legislative and regulatory developments in the last decade have radically changed the business environment for banks and savings institutions.

1.03 Although banks and savings institutions continue in their traditional role as financial intermediaries, the ways in which they carry out that role have become increasingly complex. Under continuing pressure to operate profitably, the industry has adopted innovative approaches to carrying out the basic process of gathering and lending funds. Management of complex assets and liabilities, searches for additional sources of income, reactions to technological advances, responses to changes in regulatory policy, and competition for deposits have all added to the risks and complexities of the business of banking. These include the following:

- Techniques for managing assets and liabilities that allow institutions to manage financial risks and maximize income have continued to evolve.
- Income, traditionally derived from the excess of interest collected from borrowers over interest paid to depositors, has become increasingly dependent on fees and other income streams from specialized transactions and services.
- Technological advances have accommodated increasingly complex transactions, such as the sale of securities backed by cash flows from other financial assets.
- Regulatory policy has alternately fostered or restricted innovation as, for example, institutions look for new transactions to accommodate changes in the amount of funds they must keep in reserve or to achieve the levels of capital that they must maintain in relation to their assets.

1.04 Increased competition has come from within the industry, but also from nontraditional players such as investment companies, brokers and dealers in securities, insurers, and financial subsidiaries of commercial enterprises. These entities now do business directly with potential depositors and borrowers in transactions traditionally executed through banks and savings institutions. This disintermediation has increased the need for innovative approaches to attracting depositors and borrowers. It has also led some in industry to call for legislation to permit banks and savings institutions to expand their services into insurance and other businesses. Competition in the latter half of the 1990s also will be affected as institutions engage in interstate branching as permitted by legislation passed in 1994.

1.05 Credit-card operations are an example of a banking activity that reflects the innovations and complexities of today's banks and savings institutions industry. Basically another means of lending, credit-card operations provide additional income through interest charges and related fees. Technological advances have made it possible to trade assets backed by cardholders' outstanding balances. Sales of such securities can be helpful in the institution's management of its other assets and liabilities, as well as in the maintenance of regulatory capital levels. At the same time, competition from credit-card operations outside the banks and savings institutions industry creates pressure for further innovation.

1.06 The innovation and complexity that result from the industry's pursuit of profitable activities create a constantly changing body of business and economic risks. These risk factors, and related considerations for independent accountants, are identified and discussed throughout this Guide.

Regulation and Supervision

1.07 As discussed above, the importance of financial intermediation has driven governments to play a role in the banks and savings institutions industry from its beginning. Banks and savings institutions have been given unique privileges and protections, including federal insurance of their deposits by the Federal Deposit Insurance Corporation (FDIC) and access to the Federal Reserve System's discount window and payments system. Federal oversight of institutions receiving these privileges falls currently to four agencies (collectively, the agencies):

a. The Board of Governors of the Federal Reserve System (FRB), established in 1913 as the central bank of the United States with supervisory responsibilities for bank holding companies

b. The FDIC, established in 1934 to restore confidence in the banking system through federal insurance of deposits

c. The Office of the Comptroller of the Currency (OCC), created in 1863 to regulate and provide federal charters for national banks

d. The Office of Thrift Supervision (OTS), which replaced the Federal Home Loan Bank Board in 1989 as the primary regulator for savings institutions

1.08 The FRB and FDIC are independent agencies of the federal government. The OCC and OTS are separate bureaus of the U.S. Department of the Treasury. Separate banking agencies also exist in most states and other jurisdictions of the United States.

1.09 Although each agency has its own jurisdiction and authority, the collective regulatory and supervisory responsibilities of federal and state banking agencies include—

- Setting out (either directly or as a result of legislative mandate) the rules and regulations that govern institutions' operations.
- Supervising institutions' operations and activities.
- Reviewing and approving organization, conversion, consolidation, merger, or other changes in control of institutions and their branches.
- Appraising (in part through on-site examinations) institutions' financial condition, soundness of operations, quality of management, and compliance with laws and regulations.

1.10 Given the nature of their duties, the banking agencies also play a major role in the development of banks and savings institutions' accounting and reporting practices. As described beginning in paragraph 2.59, the agencies also have certain authority over the activities of independent accountants serving the industry. Further, the federal banking agencies and the National Credit Union Administration constitute the Federal Financial Institutions Examination Council (FFIEC). The FFIEC sets forth uniform examination and supervisory guidelines in certain areas related to banks and savings institutions activities, including those involving regulatory accounting and financial reporting.

1.11 Chapter 2 discusses the current regulatory approach to supervision of banks and savings institutions and provides an overview of major areas of regulation and related regulatory reporting. Legislative efforts over time to regulate, deregulate, and reregulate banks and savings institutions are also addressed in chapter 2. Other specific regulatory considerations are identified throughout this Guide in the relevant chapters.

1.12 In addition to supervision and regulation by the federal and state banking agencies, publicly held institutions are generally subject to requirements of federal securities laws, including the Securities Act of 1933 and the Securities Exchange Act of 1934 (Exchange Act). Institutions whose securities are registered under the Exchange Act must comply with its reporting requirements through periodic filings with the Securities and Exchange Commission (SEC). Publicly held institutions that are not part of a holding company are required under section 12(i) of the Exchange Act to make equivalent filings directly with their primary federal regulators. Each of the agencies has regulations that provide for the adoption of forms, disclosure rules, and other registration requirements equivalent to those of the SEC as mandated by the Exchange Act. (See footnote 1 in the Preface.)

Industry Risk Factors

1.13 Independent accountants with clients in the industry should be aware of the general business and economic risk factors that affect the industry.[1] There is no list of risk factors that can cover all of the complex characteristics that affect transactions in the industry. Competition for business, innovations in financial instruments, and the role of regulatory policy were introduced above. Emerging regulatory and accounting guidance are discussed

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[1] One source of such information is the AICPA's Audit Risk Alert series.

throughout this Guide. Other primary risk factors (discussed below) involve the sensitivity of institutions' earnings to changes in interest rates, liquidity, and asset quality. Independent accountants should consider all such risk factors when planning the audit of an institution's financial statements. Practical considerations of these risk factors for certain transactions are provided in each chapter where appropriate.

Interest-Rate Risk

1.14 As stated above, banks and savings institutions derive their income primarily from the excess of interest collected over interest paid. The rates of interest an institution earns on its assets and owes on its liabilities generally are established contractually for a period of time. Market interest rates change over time. Accordingly, an institution is exposed to lower profit margins (or losses) if it cannot adapt to interest-rate changes.

1.15 For example, assume an institution's assets carry intermediate- or long-term fixed rates. Assume those assets were funded with short-term liabilities. Also assume that interest rates rise by the time the short-term liabilities must be refinanced. The increase in the institution's interest expense on the new liabilities—which carry new, higher rates—will not be offset if assets continue to earn at the long-term fixed rates. Accordingly, the institution's profits would decrease on the transaction because the institution will either have lower net interest income or, possibly, net interest expense. Similar risks exist when assets are subject to contractual interest-rate ceilings, or rate-sensitive assets are funded by longer-term, fixed-rate liabilities in a decreasing-rate environment.

1.16 Several techniques might be used by an institution to minimize interest-rate risk. One approach is for the institution to continually analyze and manage assets and liabilities based on their payment streams and interest rates, the timing of their maturities, and their sensitivity to actual or potential changes in market interest rates. Such activities fall under the broad definition of asset/liability management.

1.17 One technique used in asset/liability management is measurement of an institution's asset/liability gap—that is, the difference between the cash flow amounts of interest-sensitive assets and liabilities that will be refinanced (or repriced) during a given period. For example, if the asset amount to be repriced exceeds the corresponding liability amount for a certain day, month, year, or longer period, the institution is in an asset-sensitive gap position. In this situation, net interest income would increase if market interest rates rose or decrease if market interest rates fell. If, alternatively, more liabilities than assets will reprice, the institution is in a liability-sensitive position. Accordingly, net interest income would decline when rates rose and increase when rates fell. Such gap analysis assumes that assets and liabilities will be repriced only when they mature—it does not consider opportunities to reprice principal or interest cash flows before maturity. Also, these examples assume that interest-rate changes for assets and liabilities are of the same magnitude, whereas actual interest-rate changes generally differ in magnitude for assets and liabilities.

1.18 Duration analysis is a technique that builds on gap analysis by adding consideration of the average life of a stream of cash flows. The duration of an asset or liability is measured by weighting cash flow amounts based on their timing. Accordingly, duration analysis adds a measure of the effect of the timing of interest-rate changes on earnings.

1.19 Another technique used to analyze interest-rate risk involves simulation models. These models measure the effect of changes in interest rates on the market value of an institution under a premise that interest-rate changes are not static but dynamic. Simulation analysis involves the projection of various interest-rate scenarios over future periods. The estimated cash flows for each rate scenario are discounted to arrive at a present value calculation for each rate scenario. The resulting range of probable risk exposures reflects both current and expected interest-rate risk. The rate scenarios often reflect variations of factors such as the mix of assets and liabilities and related pricing strategies. As with gap and duration analyses, if the assumptions are not valid, the results may not provide an accurate reflection of the institution's interest-rate risk.

1.20 Several ways an institution can manage interest-rate risk include—

- Selling existing assets or repaying certain liabilities.
- Matching repricing periods for new assets and liabilities—for example, by shortening terms of new loans or investments.
- Hedging existing assets, liabilities, or anticipated transactions.

1.21 An institution might also invest in more complex financial instruments intended to hedge or otherwise change interest-rate risk. Interest-rate swaps, futures contracts, options on futures, and other such derivative financial instruments often are used for this purpose. Because these instruments are sensitive to interest-rate changes, they require management expertise to be effective. Accounting and regulatory guidance for these instruments continue to evolve. Chapter 15 discusses specific accounting and regulatory guidance in this area, as well as related audit considerations.

1.22 Banks and savings institutions are subject to a related risk—prepayment risk—in falling rate environments. For example, mortgage loans and other receivables may be prepaid by a debtor so that the debtor may refund its obligations at new, lower rates. Prepayments of assets carrying the old, higher rates reduce the institution's interest income and overall asset yields. Prepayment risk is discussed further in chapter 5.

Liquidity Risk

1.23 A large portion of an institution's liabilities may be short term or due on demand, while most of its assets may be invested in long-term loans or investments. Accordingly, the institution needs to have in place sources of cash to meet short-term demands. These funds can be obtained in cash markets, by borrowing, or by selling assets. Also, the secondary-mortgage, repurchase agreement, and Euro-markets have become increasingly important sources of liquidity for banks and savings institutions. However, if an institution must resort to sales of assets or loans to obtain liquidity, immediate losses will be incurred when the effective rates those assets carry are below market rates at the time of sale. Related audit considerations are addressed in chapter 5.

1.24 The composition of an institution's deposits also affects liquidity and interest-rate risk because large volumes of deposits can be withdrawn over a short period of time. For example, if an institution receives adverse publicity, it may have difficulty retaining deposits and, therefore, become dependent on other forms of borrowing at a higher cost of funds. (Chapter 11 addresses audit considerations for deposits.)

Asset-Quality Risk

1.25 Banks and savings institutions have generally suffered their most severe losses as a result of the loss of expected cash flows due to loan defaults and inadequate collateral. For example, significant credit losses on real estate loans have occurred, due largely to downturns in regional and national real estate markets, but also because of other general economic conditions and higher-risk lending activities. Chapter 7 addresses credit losses.

1.26 Other financial assets are subject to other impairment issues—similar to credit quality—that involve subjective determinations. For example, increased prepayments of principal during periods of falling interest rates have a significant impact on the economic value of assets such as mortgage servicing rights.

1.27 Independent accountants who audit financial statements of banks or savings institutions should give particular attention to the assessment of impairment of financial assets. The independent accountant should focus on the methods used, assumptions made, and conclusions reached by management (and outside specialists relied on by management, such as appraisers) in assessing impairment of financial assets. Practical guidance is provided in subsequent chapters.

Fiduciary Risk

1.28 Many banks and savings institutions activities involve custody of financial assets, management of such assets, or both. Fiduciary responsibilities are the focus of activities such as servicing the collateral behind asset-backed securities, managing mutual funds, and administering trusts. These activities expose the institution to the risk of loss arising from failure to properly process transactions or handle the related assets on behalf of third parties. Related audit considerations are addressed in chapters 5, 8, and 17 and where relevant.

Processing Risk

1.29 Large volumes of transactions must be processed by most banks and savings institutions, generally over short periods of time. Demands placed on both computerized and manual systems can be great. These demands increase the risk that the accuracy and timeliness of related information could be impaired.

1.30 Computers are used in virtually all banks and savings institutions activities that require accurate and timely processing of large volumes of transactions, such as electronic funds transfers and check processing. Related considerations are discussed in chapters 3, 4, and 11 and where relevant.

Disclosures of Certain Significant Risks and Uncertainties

1.31 AICPA Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, requires institutions to include in their financial statements disclosures about (*a*) the nature of their operations and (*b*) the use of estimates in the preparation of their financial statements.[2] Following are illustrations of application of these disclosure requirements by a bank or savings institution.

[2] The provisions of SOP 94-6 are effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which the SOP is first applied. Early application is encouraged but not required.

Nature of Operations. ABC Institution operates seven branches in rural and suburban communities in the Midwestern United States. The Institution's primary source of revenue is providing loans to customers, who are predominantly small and middle-market businesses and middle-income individuals.

Use of Estimates in the Preparation of Financial Statements. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and that affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

1.32 If specified disclosure criteria are met, SOP 94-6 also requires institutions to include in their financial statements disclosures about (*a*) certain significant estimates and (*b*) current vulnerability due to certain concentrations. Following are a discussion and illustrations of application of SOP 94-6 by a bank or savings institution to example events and circumstances that meet the disclosure criteria.

Certain Significant Estimates

1.33 Paragraphs 12 and 13 of SOP 94-6 require disclosure regarding estimates used in the determination of the carrying amounts of assets or liabilities or in disclosure of gain or loss contingencies when information available prior to issuance of the financial statements indicates that both of the following criteria are met:

a. It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.

b. The effect of the change would be material to the financial statements.

1.34 Paragraph 14 of SOP 94-6 says the disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a change in the estimate will occur in the near term. Paragraph 14 further requires that, if the estimate involves a loss contingency covered by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, the disclosure should also include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.[3]

1.35 Following is an excerpt from chapter 19 illustrating a disclosure about the allowance for loan losses when no uncertainties meet the disclosure criteria established in SOP 94-6, paragraph 13 and FASB Statement No. 5, paragraph 10.

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[3] Paragraph 10 of FASB Statement No. 5 requires reporting entities to disclose certain loss contingencies, as follows:

> If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or *if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred*. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. [Emphasis added, footnote omitted.]

Loans Receivable. The allowance for loan losses is increased by charges to income and decreased by charge-offs (net of recoveries). Management's periodic evaluation of the adequacy of the allowance is based on the Bank's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, and current economic conditions.

1.36 The following illustrates a paragraph that might be added to the illustration in paragraph 1.35 to disclose an uncertainty that meets the disclosure criteria of paragraph 13, is a loss contingency covered by FASB Statement No. 5, and affects the estimate of loan losses for only some portion of the institution's loan portfolio:

> Three of the Institution's seven branches are in communities that were flooded in late 199X. These branches made loans to individuals and businesses affected by the flooding and the Institution considered the flood's effect in determining the adequacy of the allowance for loan losses. No estimate can be made of a range of amounts of loss that are reasonably possible with respect to that event.[4]

1.37 The following illustrates a paragraph that might be added to the illustration in paragraph 1.35 to disclose an uncertainty that meets the disclosure criteria of paragraph 13 and is a loss contingency covered by FASB Statement No. 5:

> The Institution lends primarily to individuals employed at ABC Air Force Base and businesses local to the base. On December 19, 19X1, the President of the United States ratified a plan that includes the closing of the base effective November 19X2. It is reasonably possible that a change in estimated loan losses will occur in the near term. No estimate can be made of a range of amounts of loss that are reasonably possible with respect to the base closing.[5]

1.38 Paragraph 18 of SOP 94-6 gives examples of assets and liabilities and related revenues and expenses, and of disclosure of gain or loss contingencies included in financial statements that, based on facts and circumstances existing at the date of the financial statements, may be based on estimates that are particularly sensitive to change in the near term. Besides valuation allowances for loans, examples of similar estimates often included in banks' and savings institutions' financial statements include:

- Impairment of long-lived assets, for example, assets related to marginal branches
- Estimates involving assumed prepayments, for example, discounts or premiums on certain financial assets (such as securities or loans), mortgage servicing rights and excess servicing receivables, and mortgage-related derivatives
- Lives of goodwill and identifiable intangible assets (for example, depositor or borrower relationships)

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[4] If a range of possible loss can be estimated, the last sentence might say:

> It is reasonably possible that in the near term loan losses with respect to that event could be \$5 million to \$7 million more than estimated in the allowance for loan losses.

If the possible loss can be estimated, the last sentence might say:

> It is reasonably possible that in the near term loan losses with respect to that event could be \$6 million more than estimated in the allowance for loan losses.

[5] See footnote 4 in this chapter.

1.39 For example, during 19X4, DEF Bank evaluated the profitability of its branch operations. DEF Bank determined that it will significantly change the extent or manner in which it uses a group of long-lived assets related to six of its branches. In applying paragraph 6 of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, DEF Bank determined that the sum of expected future cash flows (undiscounted and without interest charges) is no less than the carrying amounts of the assets, thus, an impairment loss has not been recognized under FASB Statement No. 121. The significant change in the extent or manner in which the assets are used, however, indicates that the estimate associated with the carrying amounts of those assets may be particularly sensitive in the near term.[6] Following is an illustrative disclosure.

> Management of DEF Bank has reevaluated and will significantly change its use of a group of long-lived assets associated with six of its branches. It is reasonably possible that the Bank's estimate of the carrying amounts of these assets will change in the near term. No estimate can be made of a range of amounts of loss that are reasonably possible.[7]

Current Vulnerability Due to Certain Concentrations

1.40 Paragraph 21 of SOP 94-6 requires institutions to disclose the concentrations described in paragraph 22 of the Statement if, based on information known to management prior to issuance of the financial statements, all of the following criteria are met:

a. The concentration exists at the date of the financial statements.

b. The concentration makes the institution vulnerable to the risk of a near-term severe impact.

c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

1.41 SOP 94-6 does not address concentrations of financial instruments. However, as discussed in chapters 5, 6, 15, and elsewhere in this Guide, FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, as amended by FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, may require disclosures about such concentrations.

1.42 The following concentrations described in SOP 94-6, paragraph 22 require disclosure if they meet the criteria of paragraph 21 of the Statement.

a. Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor.

b. Concentrations in revenue from particular products, services, or fund-raising events.

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[6] Paragraph 4 of FASB Statement No. 121 requires that an institution should "review long-lived assets and certain identifiable intangibles to be held and used for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable." A significant change in the extent or manner in which an asset is used is an example of an event or change in circumstances that (*a*) paragraph 5b of FASB Statement No. 121 says indicates that the recoverability of the carrying amount of an asset should be assessed and (*b*) paragraph 19b of SOP 94-6 says indicates that an estimate associated with the carrying amount of a long-lived asset may be particularly sensitive to change in the near term.

[7] See footnote 4 in this chapter.

c. Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations.

d. Concentrations in the market or geographic area in which an entity conducts its operations.

1.43 Examples of concentrations that may fall in one or more of these categories and that are found at certain banks or savings institutions include:

- Sale of a substantial portion of or all receivables or loan products to a single customer
- Loss of approved status as a seller to or servicer for a third party
- Concentration of revenue from issuances involving a third-party guarantee program
- Concentration of revenue from mortgage banking activities

1.44 For example, assume a significant portion of GHI Institution's net income is from sales of originated loans. In 19X4, GHI Institution originated $800 million of loans. GHI Institution sold the loans and servicing rights to a substantial portion of these loans to a single servicer, TCB. TCB has historically purchased a substantial portion of the loans and servicing originated by GHI Institution. Following is an illustrative disclosure.

A substantial portion of GHI Institution's loan and loan-servicing-right originations are sold to a single servicer.

1.45 Assume a significant portion of JKL Bank's revenues is from origination of loans guaranteed by the Small Business Administration under its Section 7 program and sale of the guaranteed portions of those loans. Funding for the Section 7 program depends on annual appropriations by the U.S. Congress. The customer base for this lending specialization and the resulting profits depend on the continuation of the program. Following is an illustrative disclosure.

A substantial portion of JKL Bank's revenues is from origination of loans guaranteed by the Small Business Administration under its Section 7 program and sale of the guaranteed portions of those loans. Funding for the Section 7 program depends on annual appropriations by the U.S. Congress.

Chapter 2

Regulation and Supervision

Introduction

2.01 Laws and their implementing regulations affect the areas and ways in which banks and savings institutions operate while creating standards with which those institutions must comply. Some laws and regulations directly address the responsibilities of independent accountants.[1]

2.02 The primary objective of this chapter is to explain why and how independent accountants should consider regulatory matters. This chapter also addresses the overall regulatory approach and environment, and the relative responsibilities of institutions, examiners, and independent accountants. Considerations independent accountants should give to specific areas of regulation are highlighted in subsequent chapters.

2.03 Independent accountants should be familiar with regulations because of the impact regulations have on independent accountants'—

a. Acceptance of engagements in the industry.

b. Planning activities (that is, development of the expected conduct and scope of an engagement).

c. Responsibility for detection of errors and irregularities.

d. Evaluation of contingent liabilities and related disclosures.

e. Consideration of an institution's ability to continue as a going concern.

2.04 As required by Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), as amended, independent accountants should consider matters affecting the industry in which the entity operates, such as government regulations. In that regard, it is helpful for independent accountants to be familiar with the nature and purpose of regulatory examinations—including the differences and relationship between examinations and financial statement audits.

2.05 Finally, an understanding of the regulatory environment in which institutions operate is necessary to complement the independent accountant's knowledge of existing regulatory requirements. Because the regulatory environment is continually changing, the independent accountant must monitor relevant regulatory changes and consider their implications in the audit process.

Regulatory Approach

2.06 The industry entered the 1990s in the midst of reregulation. The early 1980s saw the removal of interest-rate ceilings, changes in reserve requirements, and related deregulatory actions. But high losses incurred by the federal government as a result of providing deposit insurance (on both insured and uninsured deposits) drove legislation in 1989 and 1991 to increase regulatory oversight.

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[1] Although the discussion in this chapter is focused on federal regulation, it also may be useful in considering state regulatory matters, especially the impact of regulatory matters on the independent accountant. Further, the Guide does not address specific state regulations that may be relevant in the audit of financial statements.

2.07 One primary objective of regulation is to maintain the strength of the banking system, in turn, promoting and enforcing the public role of banks and savings institutions as financial intermediaries, protecting depositors, and preserving funds for federal deposit insurance. Regulations are generally associated with one or more of the following objectives: capital adequacy, asset quality, management competence, liquidity, and earnings.

2.08 Many laws and areas of regulation deal with the public role of banks and savings institutions. For example, laws and regulations exist to ensure the availability of credit to all creditworthy applicants without discrimination and to satisfy the credit needs of low- and moderate-income neighborhoods in institutions' local communities.

2.09 Other regulations deal directly with an institution's operations and, therefore, have broader financial implications. For example, rules exist that restrict the acceptance and renewal of brokered deposits based on an institution's level of capitalization.

2.10 In addition to the specific regulatory matters outlined in subsequent chapters, there are three aspects of the regulatory process that are particularly important to independent accountants: rule making, examinations, and enforcement.

Rule Making

2.11 Regulations are created by the agencies based on their ongoing authority or as specifically mandated by legislation. Proposed rules and regulations are generally published for comment in the *Federal Register*, a daily publication of the federal government. Final rules also appear in the *Federal Register* and are codified in Title 12 of the Code of Federal Regulations (12 CFR). The rules applicable to a given institution depend on the institution's charter and other factors such as whether it is federally insured and whether it is a member of the Federal Reserve System. Institutions are informed of new rules, policies, and guidance through publications of the agencies (see "Information Sources," paragraphs 2.97 through 2.102).

2.12 Discussions of specific regulatory matters found throughout this Guide should not be substituted for a complete reading of related regulations, rulings, or other documents where appropriate. Also, independent accountants should keep apprised of recent changes in regulations, as the regulatory environment is constantly changing.

Examinations

2.13 Federally insured banks and savings institutions are required to have periodic full-scope, on-site examinations by the appropriate agency. In certain cases, an examination by a state regulatory agency is accepted. Full-scope and other examinations are intended primarily to provide early identification of problems at insured institutions rather than as a basis for expressing an opinion on fair presentation of an institution's financial statements.

2.14 The scope of an examination is generally unique to each institution based on risk factors assessed by the examiner; however, general areas that might be covered include—

- Capital adequacy.
- Asset quality.
- Management.

- Earnings.
- Liquidity.
- Funds management.
- Internal systems and controls.
- Consumer affairs.
- Electronic data processing.
- Fiduciary activities.

2.15 Examinations are sometimes targeted to a specific area of operations, such as real estate lending or trust operations. Separate compliance examination programs also exist to address institutions' compliance with laws and regulations in areas such as consumer protection, insider transactions, and reporting under the Bank Secrecy Act.

2.16 An examination generally begins with a review of various background material and information, including practices, policies and/or procedures established by an institution. The examiner compares these practices, policies and/or procedures to regulatory and supervisory requirements and assesses the institution's adherence to sound fundamental principles in its day-to-day operations. Any additional detailed procedures considered necessary are then applied. A written report of procedures and findings is then prepared by the examiner. The relationship between the work of the examiner and that of the independent accountant is further discussed below. (The term *examiner* as used in this Guide means those individuals—acting on behalf of a regulatory agency—responsible for supervising the performance and/or preparation of reports of examination and, when appropriate, supervisory personnel at the district and national level.)

2.17 Results of examinations are also used in assigning the institution a rating under regulatory rating systems. An institution's CAMEL rating relates to capital adequacy, asset quality, management, earnings, and liquidity. Further, the Board of Governors of the Federal Reserve System (FRB) assigns BOPEC ratings to bank holding companies based on consideration of the bank's CAMEL rating, operation of significant nonbanking subsidiaries, the parent's strength and operations, earnings of the banking organization, and capital of the banking organization. Both systems involve a 5-point rating scale, 1 being the highest possible rating.

Enforcement

2.18 Regulatory enforcement is sometimes carried out through a written agreement between the regulator and the institution—ranging from the least severe commitment letter to a cease-and-desist order. Among other actions that can be taken, the agencies may enforce regulations by—

- Ordering an institution to cease and desist from certain practices or violations.
- Removing an officer or prohibiting an officer from participating in the affairs of the institution or the industry.
- Assessing civil money penalties.
- Terminating insurance of an institution's deposits.

2.19 Further, other mandatory and discretionary actions may be taken by regulators under prompt corrective action provisions of the Federal Deposit

Insurance Act (FDI Act). As described below, possible actions range from the restriction or prohibition of certain activities to appointment of a receiver or conservator of the institution's net assets.

2.20 Many enforcement actions—such as civil money penalties—apply not only to an insured bank or savings institution but also to a broader class of institution-affiliated parties, which could include independent accountants. For example, regulatory agencies may assess civil money penalties of up to $1 million per day against an institution or institution-affiliated party that violates a written agreement or any condition imposed in writing by the agency, breaches a fiduciary duty, or engages in *unsafe or unsound* practices. Because the term *unsafe or unsound* is not defined in any law or regulation, the potential liability of institution-affiliated parties is great.

2.21 The FDI Act also authorizes the agencies—on a showing of good cause—to remove, suspend, or bar an independent accountant from performing engagements required under the FDI Act. Regulations defining *good cause* have not been proposed or issued.

Regulatory Environment and Trends

2.22 The current regulatory environment reflects congressional reactions to losses incurred under federal deposit insurance programs. Both the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation (FDIC) Improvement Act of 1991 (FDICIA) were geared toward protection of federal deposit insurance funds through early detection of and intervention in problem institutions, with an emphasis on capital adequacy.

2.23 Declining real estate markets in the mid-1980s contributed heavily to widespread losses in the savings institutions industry, evidenced by insolvency of the industry's federal deposit insurance fund. FIRREA provided funds for resolution of thrift institutions, replaced the existing regulatory structure, introduced increased regulatory capital requirements, established limitations on certain investments and activities, and enhanced regulators' enforcement authority. FIRREA redefined responsibilities for federal deposit insurance by designating the separate insurance funds, the Bank Insurance Fund (BIF) and Savings Associations Insurance Fund, respectively. FIRREA also established the Resolution Trust Corporation (RTC) to dispose of the assets of failed thrifts.

2.24 As the 1980s came to a close, record numbers of bank failures began to drain the BIF. FDICIA provided additional funding for the BIF but also emphasized least-cost resolution of institutions and improved supervision and examinations. FDICIA also focused the regulatory enforcement mechanism on capital adequacy. Many of FDICIA's provisions were amendments or additions to the FDI Act.

2.25 Political fallout from these drains on federal deposit insurance funds and controversy over the funding of the RTC have been joined by various other economic and social issues affecting trends in regulations. These issues are causing policymakers to rethink both the public role of federally insured banks and savings institutions and the approach to regulation of the industry.

2.26 Key economic issues affecting regulations are centered on the ability of banks and savings institutions to operate profitably—for example, the costs and benefits of regulations, effects of unemployment and future corporate layoff plans, levels of interest rates, and the availability of credit.

2.27 Racial and ethnic disparities in residential lending and the extent of institutions' environmental liability are two of many social issues receiving increased focus in federal regulation.

Regulatory Capital Matters

2.28 Capital is the primary tool used by regulators to monitor the financial health of insured banks and savings institutions. Regulatory intervention is focused primarily on an institution's capital levels relative to regulatory standards. The agencies have a uniform framework for prompt corrective regulatory action, as well as specific capital adequacy guidelines set forth by each agency.[2]

2.29 In addition to assessing financial statement disclosures, the independent accountant considers regulatory capital from the perspective that noncompliance or expected noncompliance with regulatory capital requirements may be a condition, when considered with other factors, that could indicate substantial doubt about an entity's ability to continue as a going concern. This discussion provides an overview to help independent accountants understand regulatory capital requirements. Capital regulations are complex and their application by management requires a thorough understanding of specific requirements and the potential impact of noncompliance. Accordingly, relevant regulations and regulatory guidance should be consulted by the independent accountant as necessary when considering regulatory capital matters.

Capital Adequacy

2.30 The FDIC, Office of the Comptroller of the Currency (OCC), and FRB have historically had common capital adequacy guidelines (which differ in some respects from those of the Office of Thrift Supervision [OTS]) involving minimum (*a*) leverage capital and (*b*) risk-based capital requirements. A summary of the general requirements follows. Specific requirements are set forth in 12 CFR and in instructions for Federal Financial Institutions Examination Council (FFIEC) Consolidated Reports of Condition and Income and OTS Thrift Financial Reports (collectively, *call reports*). Call reports, which are required to be filed quarterly, contain certain financial information, including that used in calculating regulatory capital amounts.

2.31 The first requirement establishes a minimum ratio of capital as a percentage of total assets. The FDIC, OCC, and FRB require institutions to maintain a minimum leverage ratio of Tier I capital (as defined) to total average assets based on the institution's rating under the regulatory CAMEL rating system. Institutions with CAMEL ratings of 1 that are not anticipating or experiencing significant growth and have well-diversified risk are required to maintain a minimum leverage ratio of 3.0 percent. An additional 100 to 200 basis points are required for all but these most highly rated institutions.

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[2] This chapter discusses federal capital requirements. Separate state requirements may exist that also should be considered for purposes of assessing the entity's ability to continue as a going concern.

2.32 The second requirement also establishes a minimum ratio of capital as a percentage of total assets but gives weight to the relative risk of each asset, including off-balance-sheet positions. The FDIC, OCC, and FRB require institutions to maintain a minimum ratio of Tier I capital to risk-weighted assets of 4.0 percent. Banks must also maintain a minimum ratio of total capital to risk-weighted assets of 8.0 percent. Banks are expected to maintain capital above these minimum levels.

2.33 The OTS requires savings institutions also to maintain a minimum core-capital ratio (as defined) of 3.0 percent and a tangible capital requirement of 1.5 percent of assets. The determination of tangible capital requires the immediate deduction of all unamortized supervisory goodwill arising from the purchase of a troubled institution prior to April 12, 1989.

2.34 For savings associations, the OTS-required minimum total risk-based capital ratio (that is, the total of core and supplemental capital) is also 8.0 percent. The minimum requirement for core capital included in total thrift risk-based capital is 4.0 percent.

2.35 FDICIA Section 305(b) requires the agencies to revise their risk-based capital guidelines as necessary to ensure adequate consideration of interest-rate risk. The FDIC, OCC, and FRB have proposed, but not finalized, a measure of interest-rate risk exposure and an approach to assessing capital adequacy for interest-rate risk as proposed revisions to their existing risk-based capital guidelines.

2.36 The OTS includes an interest-rate risk component in its risk-based capital requirements. Institutions with a greater than normal interest-rate risk exposure (as defined) must take a deduction—from the total capital available to meet their risk-based capital requirement—equal to half the difference between the institution's actual measured exposure and a defined normal level of exposure.

2.37 Institutions are required to report certain financial information to regulators in quarterly call reports, which include amounts used in calculations of the institution's various regulatory capital amounts.

Prompt Corrective Action

2.38 FDICIA made capital an essential tool of regulators to monitor the financial health of insured banks and savings institutions. Regulatory intervention is now focused primarily on an institution's capital levels relative to regulatory standards. Through Section 38 of the FDI Act, FDICIA added (to the existing capital adequacy guidelines set forth by each agency) a uniform framework for prompt corrective regulatory action.[3]

2.39 Section 38 provides for supervisory action at certain institutions based on their capital levels. Each institution falls into one of five regulatory capital categories based primarily on three capital measures: Tier I leverage; total risk-based; and Tier I risk-based capital. These capital ratios are defined in the same manner for Section 38 purposes as under the respective agencies' capital adequacy guidelines and regulations. For savings institutions, Tier I leverage capital is comparable to core capital (as defined).

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[3] The final rules implementing prompt corrective action were published in the September 29, 1992, *Federal Register*, in the FDIC's Financial Institution Letter (FIL) 70-92, and in the OCC's Banking Bulletin 92-52 and Banking Circular 268 and the FRB's Regulation H, 12 CFR 208 Subpart B.

2.40 Regulations also specify a minimum requirement for tangible equity, which is defined as Tier I capital plus cumulative perpetual preferred stock, net of all intangibles except limited amounts of mortgage-servicing rights (MSRs), net of disallowed deferred tax assets. In calculating the tangible capital ratio, intangibles (except for qualifying MSRs, net of disallowed deferred tax assets should also be deducted from total assets included in the ratio denominator.

2.41 An institution may be reclassified between certain capital categories if its condition or an activity is deemed by regulators to be *unsafe or unsound.* A change in an institution's capital category initiates certain mandatory—and possibly additional discretionary—action by regulators.

2.42 Under Section 38, an institution is considered—

a. *Well capitalized* if its capital level *significantly exceeds* the required minimum level for each relevant capital category.

b. *Adequately capitalized* if its capital level *meets* the minimum levels.

c. *Undercapitalized* if its capital level *fails to meet* the minimum levels.

d. *Significantly undercapitalized* if its capital level *is significantly below* the minimum levels.

e. *Critically undercapitalized* if it has a ratio of tangible equity to total assets (as defined) of 2 percent or less, or otherwise fails to meet the critical capital level (as defined).

2.43 The minimum levels are defined as follows:

Category	*Total Risk-based Ratio (%)*		*Tier 1 Risk-based Ratio (%)*		*Tier 1 Leverage Capital Ratio (%)*
Well capitalized	≥10	and	≥ 6	and	≥ 5
Adequately capitalized	≥ 8	and	≥ 4	and	≥ 4*
Undercapitalized	< 8	or	< 4	or	< 4*
Significantly undercapitalized	< 6	or	< 3	or	< 3

*3.0 percent for institutions with a rating of one under the regulatory CAMEL or related rating system that are not anticipating or experiencing significant growth and have well-diversified risk (as defined).

2.44 As noted above, critically undercapitalized institutions are those having a ratio of tangible equity to total assets of 2 percent or less.

2.45 An institution will not be considered well capitalized if it is under a capital-related cease-and-desist order, formal agreement, capital directive, or prompt corrective action capital directive.

2.46 Actions that may be taken under the prompt corrective action provisions range from the restriction or prohibition of certain activities to appointment of a receiver or conservator of the institution's net assets.

2.47 Regulators will also require undercapitalized institutions to submit a plan for restoring the institution to an acceptable capital category. For example, each undercapitalized institution is required to submit a plan that specifies—

- Steps the institution will take to become adequately capitalized.
- Targeted capital levels for each year of the plan.
- How the institution will comply with other restrictions or requirements put into effect.
- Types and levels of activities in which the institution will engage.

2.48 Savings institutions that are complying with capital plans approved by the OTS prior to December 19, 1991, are not required to file new plans and are not immediately subject to certain sanctions.

2.49 Noncompliance or expected noncompliance with regulatory capital requirements may be a condition, when considered with other factors, that could indicate substantial doubt about an entity's ability to continue as a going concern. The implementation of the prompt corrective action provisions warrants similar attention by independent accountants when considering an institution's ability to remain a going concern.

Disclosures About Regulatory Matters

Capital Matters

2.50 Noncompliance with regulatory capital requirements could materially affect the economic resources of a bank or savings institution and claims to those resources. Accordingly, at a minimum, the institution should disclose the following in the footnotes to the financial statements:

1. A description of regulatory capital requirements (*a*) for capital adequacy purposes and (*b*) established by the prompt corrective action provisions of Section 38 of the FDI Act
2. The actual or possible material effects of noncompliance with such requirements
3. Whether the institution is in compliance with the regulatory capital requirements, including the following with respect to quantitative measures:[4]
   - *a.* The institution's required and actual ratios and amounts of Tier I leverage, Tier I risk-based, and total risk-based capital and (for savings institutions) tangible capital
   - *b.* Factors that may significantly affect capital adequacy such as potentially volatile components of capital, qualitative factors, and regulatory mandates
4. As of each balance sheet date presented, the prompt corrective action category in which the institution was classified as of its most recent notification
5. As of the most recent balance sheet date, whether management believes any conditions or events since notification have changed the institution's category

2.51 If, as of the most recent balance sheet date presented, the institution is either (*a*) not in compliance with capital adequacy requirements or (*b*) considered less than adequately capitalized under the prompt corrective action provisions or (*c*) both, the possible material effects of such conditions and events on amounts and disclosures in the financial statements should be dis-

[4] These amounts may be presented in either narrative or tabular form.

closed.[5] Further, noncompliance with regulatory capital requirements may, when considered with other factors, raise substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time. Additional information that might be disclosed in situations where there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time may include—

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- Possible effects of such conditions and events.
- Management's evaluation of the significance of those conditions and events and any mitigating factors.
- Possible discontinuance of operations.
- Management's plans (including relevant prospective financial information).
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities.

Other Regulatory Matters

2.52 Other regulatory limitations may exist (such as those discussed in paragraphs 2.80 and 2.81) despite compliance with minimum regulatory capital requirements. To the extent such limitations could materially affect the economic resources of the institution and claims to those resources, they should similarly be disclosed in the footnotes to the financial statements.

Application to Holding Companies

2.53 The disclosures required by paragraphs 2.50 through 2.52 should be presented for holding companies and all significant subsidiaries.

Illustrative Disclosures

2.54 The example disclosures that follow are for illustrative purposes only. Following is an illustrative disclosure for an institution that is in compliance with capital adequacy requirements and considers itself *well capitalized* under the prompt corrective action framework:

> The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.
>
> Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth

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[5] The institution should consider also making such disclosures when one or more of the institution's actual ratios is nearing noncompliance.

in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined).[6] Management believes, as of December 31, 199X, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 199X, the most recent notification from [*institution's primary regulator*] categorized the Bank as [*well capitalized*] under the regulatory framework for prompt corrective action. To be categorized as [*well capitalized*] the Bank must maintain minimum total risk-based, Tier I risk-based, Tier I leverage ratios as set forth in the table.[7] There are no conditions or events since that notification that management believes have changed the institution's category.

The Bank's actual capital amounts and ratios are also presented in the table. A total of $XX,XXX was deducted from capital for interest-rate risk.[8]

	Actual		*For Capital Adequacy Purposes:*[9]		*To Be Well Capitalized Under Prompt Corrective Action Provisions:*[10]	
	Amount	*Ratio*	*Amount*	*Ratio*	*Amount*	*Ratio*
As of December 31, 199X:						
Total Capital (to Risk Weighted Assets)	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥8.0%	≥$X,XXX,XXX	≥10.0%
Tier I Capital (to Risk Weighted Assets)	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥4.0%	≥$X,XXX,XXX	≥6.0%
Tier I Capital (to Average Assets)	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥4.0%	≥$X,XXX,XXX	≥5.0%
As of December 31, 199W:						
Total Capital (to Risk Weighted Assets)	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥8.0%	≥$X,XXX,XXX	≥10.0%
Tier I Capital (to Risk Weighted Assets)	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥4.0%	≥$X,XXX,XXX	≥6.0%
Tier I Capital (to Average Assets)	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥4.0%	≥$X,XXX,XXX	≥5.0%

2.55 Following is an illustrative paragraph to be added to the disclosures illustrated in paragraph 2.54 when an institution considers itself *adequately capitalized*:[11]

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[6] The percentages disclosed should be those applicable to the entity. As discussed in paragraph 2.31, institutions with CAMEL ratings of 1 that are not anticipating or experiencing significant growth and have well-diversified risk are required to maintain a minimum leverage ratio of 3.0 percent. An additional 100 to 200 basis points are required for all but these most highly rated institutions.

[7] Paragraphs 2.38 through 2.49 describe the prompt corrective action ratios. For some institutions, the calculation of required amounts and ratios under the prompt corrective action framework may differ from calculations under the capital adequacy requirements. The disclosure should provide the relevant amounts and ratios accordingly.

[8] At press time, as discussed in paragraphs 2.35 and 2.36, only the OTS has finalized an interest-rate risk component to its risk-based capital requirements.

[9] See footnote 7 in this chapter.

[10] For adequately capitalized or undercapitalized institutions, this column should present the minimum amounts and ratios the institution must have to be categorized as *adequately capitalized* under the prompt corrective action framework and should include the effect of any prompt-corrective-action capital directive.

[11] See footnotes 7 and 10 in this chapter.

Under the framework, the Bank's capital levels do not allow the Bank to accept brokered deposits without prior approval from regulators [*describe the possible effects of this restriction*].

2.56 Following are illustrative paragraphs to be added to the disclosures illustrated in paragraphs 2.54 and 2.55 when an institution considers itself *undercapitalized*.[12] For a discussion about the independent accountant's consideration of noncompliance, see paragraph 2.80.

The Bank may not issue dividends or make other capital distributions, and may not accept brokered or high rate deposits, as defined, due to the level of its risk-based capital. [*Describe the possible effects of these restrictions.*]

Under the regulatory framework for prompt corrective action, the Bank's capital status may preclude the Bank from access to borrowings from the Federal Reserve System through the discount window. [*Describe the possible effects of these restrictions.*] Also, as required by the framework, the Bank has a capital plan that has been filed with and accepted by the Federal Deposit Insurance Corporation (FDIC). The plan outlines the Bank's steps for attaining the required levels of regulatory capital. Management believes, at this time, that the Bank will meet all the provisions of the capital plan and all the regulatory capital requirements by December 31, 199Y (or earlier if stated in the capital plan). [*The disclosure should continue with discussion of management plans such as reducing the size of the institution by converting noncash assets and reducing liabilities, issuing additional equity securities at prices less than book value, or other plans for financial restructuring.*]

2.57 Following is an illustrative table for presentation in consolidated financial statements for a bank (or savings and loan association) holding company and each significant subsidiary:

	Actual		*For Capital Adequacy Purposes:*[13]		*To Be Well Capitalized Under Prompt Corrective Action Provisions:*[14]	
	Amount	*Ratio*	*Amount*	*Ratio*	*Amount*	*Ratio*
As of December 31, 199X:						
Total Capital (to Risk Weighted Assets):						
Consolidated	**$X,XXX,XXX**	**X.X%**	**≥$X,XXX,XXX**	**≥X.X%**	**N/A**	
Subsidiary Bank A	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥X.X%	≥$X,XXX,XXX	≥X.X%
Subsidiary Bank B	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥X.X%	≥$X,XXX,XXX	≥X.X%
Subsidiary Bank C	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥X.X%	≥$X,XXX,XXX	≥X.X%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	**$X,XXX,XXX**	**X.X%**	**≥$X,XXX,XXX**	**≥X.X%**	**N/A**	
Subsidiary Bank A	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥X.X%	≥$X,XXX,XXX	≥X.X%
Subsidiary Bank B	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥X.X%	≥$X,XXX,XXX	≥X.X%
Subsidiary Bank C	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥X.X%	≥$X,XXX,XXX	≥X.X%
Tier 1 Capital (to Average Assets):						
Consolidated	**$X,XXX,XXX**	**X.X%**	**≥$X,XXX,XXX**	**≥X.X%**	**N/A**	
Subsidiary Bank A	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥X.X%	≥$X,XXX,XXX	≥X.X%
Subsidiary Bank B	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥X.X%	≥$X,XXX,XXX	≥X.X%
Subsidiary Bank C	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥X.X%	≥$X,XXX,XXX	≥X.X%

[12] See footnotes 7 and 10 in this chapter.

[13] See footnote 7 in this chapter.

[14] See footnote 10 in this chapter.

	Actual		For Capital Adequacy Purposes:[13]		To Be Well Capitalized Under Prompt Corrective Action Provisions:[14]	
	Amount	*Ratio*	*Amount*	*Ratio*	*Amount*	*Ratio*
As of December 31, 199W:						
Total Capital (to Risk Weighted Assets):						
Consolidated	**$X,XXX,XXX**	**X.X%**	**≥$X,XXX,XXX**	**≥X.X%**	**N/A**	
Subsidiary Bank A	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥X.X%	≥$X,XXX,XXX	≥X.X%
Subsidiary Bank B	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥X.X%	≥$X,XXX,XXX	≥X.X%
Subsidiary Bank C	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥X.X%	≥$X,XXX,XXX	≥X.X%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	**$X,XXX,XXX**	**X.X%**	**≥$X,XXX,XXX**	**≥X.X%**	**N/A**	
Subsidiary Bank A	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥X.X%	≥$X,XXX,XXX	≥X.X%
Subsidiary Bank B	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥X.X%	≥$X,XXX,XXX	≥X.X%
Subsidiary Bank C	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥X.X%	≥$X,XXX,XXX	≥X.X%
Tier 1 Capital (to Average Assets):						
Consolidated	**$X,XXX,XXX**	**X.X%**	**≥$X,XXX,XXX**	**≥X.X%**	**N/A**	
Subsidiary Bank A	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥X.X%	≥$X,XXX,XXX	≥X.X%
Subsidiary Bank B	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥X.X%	≥$X,XXX,XXX	≥X.X%
Subsidiary Bank C	$X,XXX,XXX	X.X%	≥$X,XXX,XXX	≥X.X%	≥$X,XXX,XXX	≥X.X%

Auditing of Regulatory Disclosures

2.58 In addition to testing of disclosures, as discussed in paragraphs 2.103 through 2.115, below, the independent accountant should consider the implications of capital noncompliance, as discussed beginning in paragraph 2.80 and in chapter 18.

The Impact of Regulatory Matters on the Independent Accountant

2.59 The following paragraphs outline the independent accountant's responsibility for and approach to regulatory matters.

Regulatory Requirements for Independent Reporting

2.60 The primary source of independent reporting requirements is Section 36 of the FDI Act, as added by the FDICIA. Section 36 establishes reporting requirements for reports by managements and independent accountants. It also establishes minimum qualifications for independent accountants serving the affected institutions. The underlying provisions, as summarized below, apply to each FDIC-insured depository institution having total assets of $500 million or greater at the beginning of its fiscal year. Despite the asset threshold, Section 36 does not override any non-FDICIA requirements for audited financial statements or other requirements that an institution exempt from Section 36 must otherwise satisfy.[15]

[15] In FIL 43-93, the FDIC noted that, in adopting the final rule implementing Section 36, the FDIC Board reiterated its belief that "every depository institution, regardless of size or charter, should voluntarily have an annual audit of its financial statements by an independent public accountant and establish an independent audit committee."

2.61 Notwithstanding the FDI Act requirements, the FRB requires certain bank holding companies to submit audited financial statements (under authority of 12 CFR Subpart 225.5 [Regulation Y]). Also, the OTS may require audited financial statements from certain savings institutions or savings institutions holding companies in circumstances described in 12 CFR Subpart 562.4.

2.62 To implement the FDICIA requirements, the FDIC issued both a final regulation and accompanying guidelines and interpretations (*guidelines*).[16] The general requirements are summarized below; the side-by-side analysis of the detailed regulation and guidelines presented in appendix D provides more specific information.

2.63 ***Annual Report.*** Management is required to prepare, annually, a report that includes the following:[17]

- Financial statements prepared in conformity with generally accepted accounting principles (GAAP).
- A written assertion about the effectiveness at year-end of the institution's internal controls over financial reporting.
- A written assertion about the institution's compliance during the year with (*a*) federal laws and regulations relative to insider loans and (*b*) federal and state laws and regulations relative to dividend restrictions.

2.64 Management also must include a statement about its responsibilities for the financial statements, financial reporting controls, and compliance with laws and regulations. Management must engage an independent accountant to provide the following reports annually:

a. An audit report on financial statements prepared in conformity with GAAP

b. An examination-level attestation report on management's assertion about financial reporting controls

c. An agreed-upon procedures level attestation report on management's assertion about compliance with insider loan and dividend restriction laws and regulations

2.65 The financial statement audit is to be performed in accordance with generally accepted auditing standards (GAAS). The examination of management's assertion about financial reporting controls and the agreed-upon procedures report on management's compliance assertion are to be performed in accordance with Statements on Standards for Attestation Engagements (SSAEs).

2.66 The audited financial statements and other reports of management and the independent accountant must be filed with the FDIC and other regulatory agencies within the ninety days following the institution's fiscal year-end. Management must also file any management letter, qualification, or other report within fifteen days following receipt from the independent accountant.

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[16] The regulation and guidelines implementing Section 36 of the FDI Act (which have been reproduced in appendix D) are codified in 12 CFR Part 363. The regulation was published in the *Federal Register* on June 2, 1993, and in the FDIC's FIL 41-93.

[17] The reporting requirements may be satisfied for certain subsidiaries through reporting by their holding companies. These exemptions are discussed in 12 CFR Subpart 363.1 of the rule and in guidelines 2 through 4 therein.

2.67 All of management's reports will be made publicly available. The independent accountant's report on the financial statements and attestation report on financial reporting controls will also be made publicly available. The independent accountant's compliance attestation report and any management letter, while filed with the FDIC and other agencies, will not be publicly available.

2.68 ***Qualifications of Independent Accountants.*** Acceptance of an engagement to report under Section 36 is conditioned on the independent accountant being enrolled in a practice-monitoring program. Membership in the AICPA Division for CPA Firms' SEC Practice Section or Private Companies Practice Section, or enrollment in the AICPA's Peer Review Program, will satisfy this requirement.

2.69 Another condition of the engagement is that the independent accountant agrees to provide regulators with access to working papers related to the three engagement reports. The implementing guidelines call also for providing copies of working papers to regulators, although this requirement is not explicit in the law or regulation. Independent accountants should be familiar with Auditing Interpretation No. 1 of SAS No. 41, *Working Papers*, entitled "Providing Access to or Photocopies of Working Papers to a Regulator" (AICPA, *Professional Standards*, vol. 1, AU sec. 9339).

2.70 The accountant must meet the independence requirements and interpretations of the Securities and Exchange Commission (SEC) and its staff.

2.71 The implementing regulation requires both management and independent accountants to provide certain notifications of changes in an institution's independent accountants within specified time periods. Independent accountants must also file peer review reports within fifteen days of acceptance of the report.

2.72 ***Enforcement Actions Against Accountants.*** Section 36 of the FDI Act also provides for enforcement actions against accountants with respect to the Section 36 requirements. However, the FDIC has not yet proposed or published rules or guidelines to implement this statutory requirement.[18]

2.73 ***Communication With Independent Accountants.*** As described in paragraph 2.89, each institution must provide its independent accountant with copies of the institution's most recent reports of condition and examination; any supervisory memorandum of understanding or written agreement with any federal or state regulatory agency; and a report of any action initiated or taken by federal or state banking regulators.

Planning

2.74 As discussed in chapter 3, one of the key factors in planning and supervising an engagement is knowledge of the client's business. The independent accountant should obtain knowledge about regulatory matters and developments as part of the understanding of an institution's business. The independent accountant should also consider the results of regulatory examinations, as discussed beginning in paragraph 2.13.

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[18] Section 36(g)(4) of the FDI Act states that the FDIC or the appropriate agency may "remove, suspend, or bar an independent public accountant, upon a showing of good cause, from performing audit services" required by Section 36. The agencies are expected to jointly issue rules as Subpart Q of 12 CFR Part 308, to implement this provision.

Detection of Errors and Irregularities

2.75 In planning a financial statement audit, the independent accountant should assess the risk that errors or irregularities might cause the financial statements to be materially misstated. Based on that assessment, the independent accountant should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements.

2.76 As discussed in chapter 3, SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), lists management, operating, industry, and engagement characteristics that the independent accountant should consider when assessing this risk. Noncompliance with laws and regulations (for example, noncompliance with regulatory capital requirements) is one indicator of higher risk that is especially relevant in the industry. Events of noncompliance are often described in—

- Regulatory reports.
- Cease-and-desist orders or other regulatory actions, whether formal or informal.

2.77 The independent accountant has similar responsibility for detecting misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts. SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), defines illegal acts as violations of laws or governmental regulations and explains the independent accountant's responsibilities.

2.78 Apart from performing a financial statement audit, an independent accountant may be engaged to issue an SSAE report on procedures and findings on management's written assertion about the institution's compliance with laws and regulations. Under SSAE No. 3, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1, AT sec. 500), as amended, if knowledge of noncompliance leads the independent accountant to question whether management's assertion is fairly stated, such information should be included in the independent accountant's report.

Evaluation of Contingent Liabilities and Related Disclosures

2.79 Management's financial statement assertions include those about the completeness, presentation, and disclosure of liabilities. Because some areas of regulation relate more to operations than to financial reporting or accounting, consideration of compliance in those areas would normally be limited to evaluation of disclosures of any contingent liability based on alleged or actual violation of the law.

Going Concern Considerations

2.80 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), as amended, describes the independent accountant's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. SAS No. 59 states that the independent accountant must consider, in the aggregate, conditions or events that could indicate such substantial doubt. In addition to the matters discussed in paragraphs 3.45 through 3.54, the independent accountant's consideration should include regulatory matters such as—

- Noncompliance with laws and regulations.
- Supervisory actions or regulatory changes that place limitations or restrictions on operating activities.
- Classification of the institution under prompt corrective action provisions of the FDI Act (see paragraphs 2.38 through 2.49).

2.81 For example, regulatory changes in 1992 placed new restrictions on the acceptance of brokered deposits by certain institutions. This change had two implications: it potentially limited sources of liquidity and created a compliance requirement. An independent accountant auditing the financial statements of an institution subject to these restrictions would need to evaluate whether the effect on the institution's liquidity, when considered with other factors, raised substantial doubt about the institution's ability to remain a going concern for a reasonable period of time. The independent accountant would also need to consider the financial statement effects of any known event of noncompliance with the requirement itself. Examples of other events or conditions that would warrant the independent accountant's consideration are described in subsequent chapters (chapters 3 and 18 provide guidance on auditing and reporting going concern issues, respectively). They include—

- The continued existence of conditions that brought about previous regulatory actions or restrictions.
- Effects of scheduled increases in deposit insurance premiums.
- Failure to meet minimum regulatory capital requirements.
- Limitations on the availability of borrowings through the Federal Reserve System discount window.
- Exposure to the institution posed by transactions with correspondent banks and related limitations on interbank liabilities.

Regulatory Accounting Practices (RAP) and RAP-GAAP Differences

2.82 General purpose financial statements are prepared in accordance with GAAP. However, financial information provided to the agencies may be prepared on another basis—RAP—to satisfy specific regulatory objectives. As discussed in paragraph 2.37, regulations require insured banks and savings institutions to file quarterly RAP-basis call reports. These reports are used by regulators as a basis for supervisory action, a source of statistical information, and other such purposes.

2.83 FDI Act Section 37(a)(2) requires that reports and other regulatory filings follow accounting principles uniform and consistent with GAAP. Regulators are permitted, for regulatory reporting purposes, however, to prescribe an accounting principle that is no less stringent than GAAP if they believe the more stringent principle will—

a. More accurately reflect the capital of insured banks and savings institutions.

b. Provide for more effective supervision.

c. Better facilitate prompt corrective action and least-cost resolution of troubled institutions.

2.84 Certain differences between RAP and GAAP amounts as computed for regulatory and general purpose reporting, respectively, may warrant consideration by the independent accountant. For example, the Financial Accounting Standards Board's (FASB's) Emerging Issues Task Force (EITF) reached a consensus on Issue No. 85-44, *Differences between Loan Loss Allowances for GAAP and RAP*, that an institution could record different loan loss allowances under RAP and GAAP because those amounts may differ due to the subjectivity involved in estimating the amount of loss or the use of arbitrary factors by regulators. However, independent accountants should be particularly skeptical of such RAP-GAAP differences in loan loss allowances and must justify them based on the circumstances.

2.85 Some of the other areas where accounting practices *for regulatory reporting purposes* differ from GAAP include the following. Other differences are created by RAP requirements for certain reclassifications of balance sheet and income statement amounts within regulatory financial reports.

- *Hedge Accounting*. OTS-regulated thrifts are permitted to follow GAAP as established in FASB Statement of Financial Accounting Standards No. 80, *Accounting for Futures Contracts*, but the other agencies do not generally permit deferral of losses on futures and forward or standby contracts other than for futures and forward contracts used in mortgage banking operations.[19]
- *Excess Servicing Fee Receivables*. The OTS follows GAAP (as described in paragraph 8.14) and allows the present value of future excess servicing fees to be treated as an adjustment to the recognized gain or loss on sale. Except for sales of pools of residential first mortgages (as defined), the FDIC, FRB, and OCC require excess servicing fee income to be recognized as earned.
- *In-Substance Defeasance of Debt*. The OTS follows GAAP as established by FASB Statement No. 76, *Extinguishment of Debt*. The other agencies require banks to continue to report defeased debt as a liability and to record any funds placed in trust as assets—without netting.
- *Sales of Assets With Recourse*. The OTS follows GAAP as established by FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*. The other agencies generally require sales of assets with recourse to be accounted for as financings and permit banks to report such transfers as sales only when the transferor (*a*) retains no risk of loss from the assets transferred and (*b*) has no obligation for the payment of principal or interest on the assets transferred. However, this rule generally does not apply to transfers of one-to-four family or agricultural mortgage loans made under programs of Ginnie Mae, Farmer Mac, Fannie Mae, and Freddie Mac (see chapter 8), which are generally treated as sales in regulatory financial reports.[20]

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[19] The FASB has a project under way that could significantly change the way futures, forward, option, swap, and other similar financial contracts are recognized and measured. The project might also develop consistent and comprehensive standards for hedge accounting.

[20] In October 1995, the FASB issued a proposed Statement, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The proposed Statement would significantly affect accounting for (including disclosures about) securitizations, sales of partial interests, servicing assets and liabilities, securities lending transactions, repurchase agreements, "wash sales," loan syndications and participations, risk participations in banker's acceptances, factoring arrangements, and transfers of receivables with recourse.

Comments on the proposed Statement were due in January 1996. Readers should be alert to any final pronouncement.

- *Valuation of Real Estate Owned* (REO). OTS policy says:

  > . . . general allowances on REO should be established where holding period costs or losses on disposition are not otherwise reflected in the carrying value. The level of any general allowance on REO should be based on historical net loss experience, adjusted for current conditions and trends.

  The other agencies follow AICPA Statement of Position 92-3, *Accounting for Foreclosed Assets* (see paragraph 9.08).
- *Valuation of Certain Intangibles*. The agencies require MSRs and purchased credit card relationships (PCCRs) to be recorded at an amount no greater than the discounted value of their future net servicing income. The agencies further limit the aggregate amount of such intangibles that may be included in regulatory capital. Also, the agencies generally require that intangible assets be amortized for regulatory reporting purposes over no more than fifteen years. The amortization period for core deposit intangibles of national banks is further limited to ten years. The OCC generally further limits the amortization period for PCCRs to ten years.
- *Push-Down Accounting*. In certain circumstances, an acquired bank or savings institution uses the acquiring institution's basis of accounting in preparing the acquired institution's financial statements. These circumstances are addressed for SEC registrants in SEC Staff Accounting Bulletin No. 54, *Application of "Push Down" Basis of Accounting in Financial Statements of Subsidiaries Acquired by Purchase*. In EITF Issue No. 86-9, *IRC Section 338 and Push-Down Accounting*, the EITF reached a consensus that such push-down accounting is not required for companies that are not SEC registrants. However, push-down accounting is required by the FDIC, OCC, and FRB when there is at least a 95 percent change in ownership and by the OTS when there is at least a 90 percent change in ownership.
- *Offsetting*. The OTS follows GAAP established in FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, and FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*. The other agencies generally prohibit netting of assets and liabilities, except for assets and liabilities that arise from off-balance-sheet instruments when certain criteria are met.

2.86 Further, there are certain transactions accounted for in conformity with GAAP for regulatory reporting purposes that receive special treatment in regulatory capital calculations, including the following:

- Institutions are permitted to include a limited amount of the allowance for loan losses in Tier II capital, whereas these amounts reduce assets (rather than increase capital) for GAAP purposes.
- Only a limited amount of certain deferred tax assets recognized under FASB Statement No. 109, *Accounting for Income Taxes*, may be included in Tier I capital.
- Net unrealized holding losses on equity securities classified as available for sale in conformity with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, are included in calculation of Tier I capital. However, all other unrealized holding gains and losses on available-for-sale securities are not included in calculation of Tier I capital.

- The OTS permits negative goodwill for one transaction to be offset against goodwill recorded as an asset for another transaction.

Independent Accountant/Examiner Relationship

2.87 Independent accountants may be engaged to attest to the fairness of presentation of the institution's financial statements and to management's assertions about the institution's financial reporting controls and compliance with laws and regulations. Banking regulators conduct periodic on-site examinations to address broader regulatory and supervisory issues. There are some objectives shared by examiners and independent accountants, and coordination in consultation with the institution may be beneficial.

2.88 The primary objective of communicating with examiners is to ensure that independent accountants consider competent evidential matter produced by examiners before expressing an opinion on audited financial statements. In areas such as the adequacy of credit loss allowances and violations of laws or regulations, for example, information known to or judgments made by examiners should be made known to management and the independent accountant before financial statements are issued or an audit opinion is rendered. Such communication will minimize the possibility that a regulatory agency will subsequently require restatement—based on the examiner's additional knowledge or different judgment—of call reports and affect the general purpose financial statements, on which the independent accountant has already expressed an opinion, dated during or subsequent to the period in which a regulatory examination was being conducted.

2.89 FDI Act Section 36(h) requires that each institution provide its independent accountant with copies of the institution's most recent call report and examination report (see 12 CFR Subpart 363.403). The institution must also provide the independent accountant with any of the following documents related to the period covered by the engagement:

a. Any memorandum of understanding (MOU) or other written agreement between the institution and any federal or state banking agency

b. The report of any action initiated or taken by any federal or state banking agency, including any assessment of civil money penalties

2.90 The independent accountant should review communications from examiners and, when appropriate, make inquiries of examiners. Specifically, the independent accountant should—

a. Request that management provide access to all reports of examination and related correspondence.

b. Review the reports of examination and related correspondence between examiners and the institution during the period under audit and through the date of the independent accountant's opinion.

c. With prior approval of the institution, communicate with the examiners if their examination is still in process, the institution's appeal of an examination finding is outstanding, or their examination report is still pending.

d. With prior approval of the institution, consider attending, as an observer, the exit conference between the examiner and the institution's board of directors, its executive officers, or both.

2.91 The independent accountant's attendance at other meetings between examiners and representatives of the institution requires prior approval by the regulatory agency.

2.92 Independent accountants may request a meeting with the appropriate regulatory representatives to inquire about supervisory matters relevant to the client institution. Management of the institution would generally be present at such a meeting, and matters discussed would generally be limited to findings already presented to management. Federal regulatory policy also permits meetings between examiners and independent accountants in the absence of the institution's management.[21] In addition, the OTS has established a policy that generally makes OTS examination working papers available for review.[22]

2.93 Management refusal to furnish access to reports or correspondence, or to permit the independent accountant to communicate with the examiner, would ordinarily be a limitation on the scope of a financial statement audit sufficient to preclude an opinion. Refusal by an examiner to communicate with the independent accountant may create the same scope limitation, depending on the independent accountant's assessment of the circumstances (see paragraphs 22 through 26 of SAS No. 58, *Reports on Audited Financial Statements* [AICPA, *Professional Standards*, vol. 1, AU sec. 508], as amended, for additional guidance).

2.94 Examiners might request permission to attend the meeting between the independent accountant and representatives of the institution (for example, the audit committee of the board of directors) to review the independent accountant's report on the institution's financial statements. If such a request is made and management concurs, the independent accountant should be responsive to the request.

2.95 Examiners and others may, from time to time, request auditors of financial statements of banks and savings institutions to provide access to working papers. Auditors who have been requested to provide such access should refer to Interpretation No. 1 of SAS No. 41. The Interpretation provides auditors with guidance on—

- Advising management that the regulator has requested access to (and possibly photocopies of) the working papers and that the auditor intends to comply with the request.
- Making appropriate arrangements with the regulator for the review.
- Maintaining control over the original working papers.
- Considering submitting to the regulator a letter clarifying that an audit in accordance with GAAS is not intended to, and does not, satisfy a regulator's oversight responsibilities. An example of such a letter is illustrated in paragraph 6 of the Interpretation.

In addition, the Interpretation addresses situations in which an auditor has been requested by a regulator to provide access to the working papers before the audit has been completed and the report released. Also, the Interpretation notes that when a regulator engages an independent party, such as another independent public accountant, to perform the working paper review on behalf of the regulatory agency, there are some precautions auditors should observe.

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[21] Related instructions to examiners were published in a July 23, 1992, *Interagency Policy Statement on Coordination and Communication Between External Auditors and Examiners.*

[22] See OTS letter to chief executive officers dated September 11, 1992.

2.96 Information in examination reports, inspection reports, supervisory discussions—including summaries or quotations—is considered confidential. Such information may not be disclosed to any party without the written permission of the appropriate agency, and unauthorized disclosure of such information could subject the independent accountant to civil and criminal enforcement actions.

Information Sources

2.97 OCC supervisory policies and guidance are issued as Advisory Letters, OCC Bulletins, Memoranda, News Releases, the Comptroller's Handbook, the Bank Accounting Advisory Series, and other issuances. For information on ordering copies of OCC issuances, call OCC Publications Control at (202) 874-4960.

2.98 FDIC policy is communicated in Financial Institution Letters, News Releases, and Memoranda and in instructions for FFIEC Consolidated Reports of Condition and Income. For information about ordering these issuances, call FDIC Corporate Communications at (202) 898-6996.

2.99 Information about FRB publications is available through FRB Publications Services at (202) 416-6940.

2.100 OTS supervisory policies and guidance are issued in the form of Thrift Bulletins, Regulatory Bulletins, and Transmittals and in guidance provided to examiners through a multivolume set of agency handbooks and in instructions for Thrift Financial Reports. For information on ordering OTS publications, call the OTS Controller's Division at (202) 906-6427.

2.101 The *Federal Register* contains notices about the actions of federal government agencies. It may be purchased from the U.S. Government Printing Office by calling (202) 512-1800 or by writing to New Orders, Superintendent of Documents, P.O. Box 371954, Pittsburgh, PA 15250-7954. Most public libraries also have copies of the *Federal Register*.

2.102 Several companies offer the regulatory releases noted above in electronic formats.

Auditing

Objectives

2.103 The independent accountant's objective in this area is to obtain reasonable assurance that the financial statements include proper description and disclosure of regulatory matters (as discussed in paragraphs 2.50 through 2.53) in the context of the financial statements taken as a whole.

2.104 Similarly, the audit objective for regulatory capital matters relates primarily to disclosure.[23] Capital amounts determined under RAP are, by definition, not recognized or measured in the institution's financial statements prepared in conformity with GAAP.

2.105 An independent accountant's report on financial statements containing the required regulatory capital disclosures does not constitute an opin-

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[23] Notwithstanding the disclosure objective, regulatory matters may also affect preparation of the independent accountant's report, as discussed in chapter 18.

ion on the fair presentation of the institution's call reports (in part or taken as a whole) in conformity with underlying call report instructions or RAP. Nor does the opinion indicate that the independent accountant has confirmed with any regulatory agency that the agency has examined or otherwise evaluated or opined on the fair presentation of such reports.

Planning

2.106 Independent accountants should have knowledge of capital regulations sufficient to understand call report instructions and to assess related application and classification decisions made by management. The independent accountant should review changes in call report instructions and related capital requirements since the preceding audit.

2.107 Paragraphs 2.87 through 2.96 discuss the independent accountant's responsibility relative to review of supervisory reports and coordination with examiners. Such review and coordination should involve consideration of matters for disclosure.

2.108 Accounting principles used in preparing call reports are required by the FDI Act to be uniform and consistent with (or no less stringent than) GAAP. While planning and carrying out procedures in other audit areas, the independent accountant should consider the potential that RAP-GAAP differences might result from the institution's transactions. This information will help the independent accountant assess differences (*a*) between GAAP equity amounts and RAP capital amounts and (*b*) between GAAP and RAP asset amounts, including risk weightings and off-balance-sheet equivalents. The information will also be useful for performing any procedures applied to such differences (including consideration of the relative risk weightings assigned to certain amounts or transactions).

2.109 In planning the audit, the independent accountant should consider factors influencing inherent risk, which are described in chapter 3, as they relate to the adequacy of disclosure about regulatory matters. Some components of regulatory capital ratios, including related amounts, asset measures, and risk weightings, may be difficult to determine due to (*a*) the complexity and subjectivity of capital regulations and related call report instructions or (*b*) the complexity of the institution's transactions. The number and variety of differences between GAAP and RAP amounts affecting the institution also will affect inherent risk in this area.

2.110 Management's regulatory financial reporting classification and risk weighting decisions involve a high degree of subjective analysis by management and might be challenged by examiners. Accordingly, such decisions that could have a material impact on regulatory disclosures should be carefully considered by the independent accountant.

2.111 The following are examples of factors related to regulatory matters that may indicate higher inherent risk and/or higher control risk:

- A high volume and/or high degree of complexity of off-balance-sheet transactions
- Actual or borderline noncompliance with minimum capital requirements
- A poor regulatory CAMEL rating
- Past disagreements between management and regulators about classifications, risk weightings, or other interpretations of RAP or application of capital regulations in general

- Frequent corrections to filed call reports
- Regulatory restrictions or other regulatory actions taken related to capital compliance (for example, any MOU issued)
- Unusual, material, or frequent related party transactions
- Capital calculations, including management's classification or risk weighting decisions, that are not well documented

Internal Control Structure Over Financial Reporting

2.112 An effective internal control structure over financial reporting in this area should provide reasonable assurance that errors or irregularities in financial statement disclosures about regulatory matters are prevented or detected. In part, these controls may overlap with controls the institution has established for compliance with capital requirements. Institutions' systems for gathering the necessary information and preparing regulatory financial reports vary in sophistication. Examples of factors that may contribute to an effective internal control structure in this area follow.

- Responsibilities for capital planning, monitoring compliance with capital laws and regulations, and preparation of call reports have been assigned to competent officials in the institution.
- Regulatory financial reporting is subject to risk assessment and supervisory control procedures and is overseen by financial officers of the institution who review the details supporting classifications and risk weightings.
- Capital amounts reported to regulators are reconciled to underlying detailed schedules and subsidiary ledgers with reconciling items supported by appropriate computations and documentation and with appropriate supervisory review and oversight.
- Procedures are in place for collection and reporting by branches, divisions, and subsidiaries of amounts necessary for regulatory capital calculations.
- Management obtains competent outside advice, as warranted, on significant classification or risk weighting questions before and after major transactions are executed.
- Regulatory capital analyses, calculations, and supporting documentation are well prepared and readily accessible.
- The regulatory financial reporting process (including classifications and risk weightings) is reviewed by the internal audit function.

Substantive Tests

2.113 The extent to which the independent accountant applies tests to specific transactions or amounts will depend on the independent accountant's assessment of inherent and control risks and the materiality of the accounts. Where inherent and control risks are assessed at lower levels, the independent accountant may consider testing a reconciliation of RAP-GAAP differences before year-end, reviewing classifications made for risk weighting purposes, reviewing examination findings, and testing material RAP-GAAP differences, risk weighting classifications, and ratio calculations in preparation for any substantive tests to be applied to disclosures of year-end amounts and ratios.

2.114 Paragraphs 2.87 through 2.96 discuss the independent accountant's responsibility relative to review of supervisory reports and coordination with examiners. Such review and coordination should involve consideration of the adequacy of the financial statement disclosures in this area.

2.115 Substantive procedures should be designed to the extent considered necessary to assess computations of regulatory capital amounts and asset measures by obtaining reasonable assurance that the underlying data are materially complete. Such procedures might include the following.

- Obtain and test management's schedules supporting calculation of the institution's actual and required regulatory capital ratios, including regulatory capital amounts (ratio numerators) and related asset bases (ratio denominators).
- Review and evaluate management's analyses of significant nonrecurring transactions and their impact on regulatory capital.
- Inquire about, and discuss with officers having responsibility for regulatory financial reporting, the existence and nature of the institution's RAP-GAAP differences. Review copies of prior-year call reports (and, as necessary, client's supporting working papers), and obtain management's analysis of classification issues concerning preparation of call reports, including risk weighting classifications assigned. In assessing the completeness of any reconciliation, consider the potential for other of the institution's transactions to produce standard RAP-GAAP differences.
- Obtain any reconciliation of amounts supporting the institution's regulatory capital ratio calculations to amounts in the institution's financial statements prepared in conformity with GAAP.[24]
  - Test management's supporting schedules and reconciliations for completeness and mathematical accuracy.
  - Agree GAAP amounts to general and/or subsidiary ledgers and obtain supporting schedules for non-GAAP amounts.
  - Review the nature and amount of material non-GAAP amounts for propriety and consistency with prior years.
- Consider current treatment of items that resulted in past corrections or changes to regulatory financial reports.
- Consider whether significant changes in instructions for preparation of call reports have been applied to material transactions.
- Inquire about, and discuss with officers having responsibility for call reporting, any significant reclassification of transactions since the last filed call report.

[24] See OTS letter to chief executive officers dated September 11, 1992.

Chapter 3
General Auditing Considerations

Scope of Services

3.01 The scope of services rendered by independent accountants generally depends on the types of reports to be issued as a result of the engagement. Early in the engagement, the independent accountant should establish an understanding with the institution's management regarding the scope of services to be performed and the reports to be issued, which may include auditing the institution's financial statements in accordance with generally accepted auditing standards (GAAS). The accountant should consider whether the scope of the work includes the engagements necessary to provide the independent accountants' reports necessary to satisfy relevant regulatory requirements, such as those engagements described in chapter 2 (see paragraph 2.60), as well as any additional legal or contractual requirements, such as—

- Auditing the financial statements of common trust funds and applying agreed-upon procedures related to trust activities. (Chapter 17 includes a description of trust services and activities.)
- Applying agreed-upon procedures in connection with a directors' examination.
- Examining or applying agreed-upon procedures to management assertions related to mortgage banking activities in accordance with Statements on Standards for Attestation Engagements (SSAEs). (See chapter 8.)
- Reporting on the processing of transactions by banks and savings institutions functioning as service organizations in accordance with Statement on Auditing Standards (SAS) No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324). (See chapters 8, 11, and 17 as they relate to loan servicing, deposits, and trust activities, respectively.)

Planning a Financial Statement Audit

3.02 The objective of an audit of an institution's financial statements is to express an opinion on whether its financial statements present fairly, in all material respects, its financial position, the results of its operations, and its cash flows in conformity with generally accepted accounting principles (GAAP). To accomplish that objective, the independent accountant assesses the risk that the financial statements contain material misstatements and plans and performs audit procedures to provide reasonable assurance that the financial statements are free of material misstatements. This section on planning the audit of the financial statements of a bank or savings institution addresses the consideration of risk at the financial statement level and general planning considerations. Consideration of audit risk at the account balance and class of transaction level is discussed in subsequent chapters.

3.03 The first standard of field work requires that audit work be adequately planned and that assistants, if any, be properly supervised. SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec.

311), as amended, provides guidance on the considerations and procedures applicable to planning and supervision, including preparing a written audit program and obtaining knowledge of the entity's business. Audit planning also involves developing an overall strategy for the conduct and scope of the audit. SAS No. 22 recognizes that the nature, timing, and extent of planning vary with the size and complexity of the entity whose financial statements are being audited, as well as with the independent accountant's experience with the entity and knowledge of the entity's business. As required by SAS No. 22, independent accountants who undertake audits of financial statements of depository institutions should possess sufficient knowledge of matters that affect such institutions, including applicable regulatory matters.

Knowledge of the Client's Business

3.04 In addition to knowledge of the industry, including matters such as those described in chapters 1 and 2, the independent accountant should have knowledge of matters that are unique to the entity whose financial statements are being audited. With regard to banks and savings institutions, such matters include risk management strategies, organizational structure, product lines and services, capital structure, locations, and other operating characteristics. The independent accountant's knowledge of the institution's business should be sufficient to provide an understanding of events, transactions, and practices that may have a significant effect on the institution's financial statements.

3.05 Knowledge of the institution's business is generally obtained through experience with the client, discussions with predecessor independent accountants (if appropriate), discussion with institution personnel, and review of pertinent documents. Such knowledge may also be obtained or supplemented by reading documents such as—

- The charter and bylaws of the institution.
- Minutes of meetings of the board of directors, audit committee, credit committee or loan officers or both, and other appropriate committees.
- Prior-year and interim financial statements and other relevant reports, such as recently issued registration statements.
- Risk management strategies and reports, such as interest rate, asset quality, and liquidity reports.
- Organizational charts.
- Operating policies, including strategies for lending and investing.
- Regulatory examination reports and Federal Financial Institutions Examination Council (FFIEC) Consolidated Reports of Condition and Income or Office of Thrift Supervision Thrift Financial Reports (collectively, *call reports*).
- Sales brochures and other marketing materials.
- Capital or business plans.

3.06 ***Related Parties.*** Obtaining knowledge of a client's business should also include performing the procedures in paragraph 2 of SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AICPA, *Professional Standards*, vol. 1, AU sec. 334, "Related Parties"), to determine the existence of related party relationships and transactions with such parties. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 57, *Related Party Disclosures*, defines *related parties* as—

a. Affiliates of the institution (a party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an institution).

b. Entities for which investments are accounted for by the equity method by the institution.

c. Trusts for the benefit of employees, such as pension and profit-sharing trusts, that are managed by or are under the trusteeship of management of the institution.

d. Principal owners of the institution.

e. Management of the institution.

f. Members of the immediate families of the principal owners of the institution and its management.

3.07 Also included in the FASB Statement No. 57 definitions of related parties are other parties with which the institution may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party is also a related party if it can significantly influence the management or operating policies of the transacting parties, or if it has an ownership interest in one of the transacting parties and can significantly influence the other to the extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

3.08 SAS No. 45 states that, in auditing related party transactions that are identified during the course of the audit, the independent accountant should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form. If the institution includes a representation in the financial statements that a related party transaction was consummated on terms equivalent to those that prevail in arm's-length transactions, and the independent accountant believes that the representation is unsubstantiated by management, he or she should express a qualified or adverse opinion because of a departure from GAAP, depending on materiality. (See SAS No. 58, *Reports on Audited Financial Statements* [AICPA, *Professional Standards*, vol. 1, AU sec. 508], as amended.)

Internal Control Structure

3.09 The assets of banks and savings institutions generally are more negotiable and more liquid than those of most other commercial enterprises. As a result, they may be subject to greater risk of loss than are the assets of most other commercial enterprises. In addition, the operations of banks and savings institutions are characterized by a high volume of transactions; as a result, the effectiveness of internal control structure policies and procedures is a significant audit consideration.[1]

3.10 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended, provides guidance on the independent accountant's consideration of an entity's internal control structure in a GAAS audit of financial

[1] This section discusses the consideration of the internal control structure in a financial statement audit; it does not address reporting on a written management assertion about financial reporting controls, such as the attestation report discussed in appendix D.

statements.[2] It describes the elements of an internal control structure and explains how an independent accountant should consider the internal control structure in planning and performing an audit. SAS No. 55 requires that, in all audits, the independent accountant obtain sufficient understanding of each of the three elements (the control environment, accounting system, and control procedures) to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

3.11 After obtaining this understanding, the independent accountant assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. The independent accountant may assess control risk at the maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the institution's internal control structure) because the independent accountant believes policies and procedures are unlikely to pertain to an assertion or are unlikely to be effective, or because evaluating their effectiveness would be inefficient. Alternatively, the independent accountant may obtain evidential matter about the effectiveness of both the design and operation of a policy or procedure that supports a lower assessed level of control risk. In such cases, the independent accountant considers whether evidential matter sufficient to support a further reduction is likely to be available and whether performing additional tests of controls to obtain such evidential matter would be efficient. Such evidential matter may be obtained from tests of controls planned and performed in accordance with SAS No. 55.[3]

3.12 The independent accountant uses the knowledge provided by the understanding of the internal control structure and the assessed level of control risk in determining the nature, timing, and extent of substantive tests for financial statement assertions.

3.13 An institution's internal control structure consists of the policies and procedures established to provide reasonable assurance that specific objectives will be achieved. The internal control structure consists of three elements:

a. The *control environment* represents the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. It reflects the overall attitude, awareness, and actions of those involved in management of the institution. Management's ability to identify and respond to general business risks and to the business and accounting implications of new

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[2] In December 1995, the Auditing Standards Board (ASB) issued SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). SAS No. 78 revises the definition and description of internal control contained in the SASs to recognize the definition and description contained in *Internal Control—Integrated Framework* published by the Committee of Sponsoring Organizations of the Treadway Commission. SAS No. 78 is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted.

In conjunction with SAS No. 78, the ASB issued SSAE No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2* (AICPA, *Professional Standards*, vol. 1, AT sec. 400). SSAE No. 6 conforms the description of elements of an entity's internal control to the components of internal control contained in SAS No. 78 and the *Internal Control—Integrated Framework*. SSAE No. 6 is effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, with earlier application permitted.

[3] Further guidance is also provided in the AICPA Audit Guide *Consideration of Internal Control in a Financial Statement Audit*.

strategies, products, and services helps to determine whether the control environment is strong or weak. Factors that affect the control environment include the nature and effectiveness of management controls, expansion into new business areas (such as those involving complex investment strategies), the enhancement of present policies, the implementation of different internal control structure policies and procedures, and the nature and extent of the involvement of the board of directors. The independent accountant should consider the degree of management's and the board of directors' involvement, expertise, and overall control with respect to general and specific business risks and transactions. Appendix A to SAS No. 55 discusses the control environment factors that the independent accountant should consider. Among those factors are external influences, including examinations by regulatory agencies, which were discussed in chapter 2.

b. The *accounting system* consists of the methods and records established to identify, assemble, analyze, classify, record, and report an institution's transactions and to maintain accountability for the related assets and liabilities.

c. *Control procedures* are those policies and procedures in addition to the control environment and accounting system that management has established to provide reasonable assurance that specific objectives will be achieved (for example, policies and procedures that provide for proper authorizations of transactions and adequate safeguards over access to and use of assets and records, such as secured safeguarding facilities and authorization for access to computer programs and files).

3.14 ***Computer Considerations.*** Depository institution operations are characterized by large volumes of transactions and, therefore, generally rely heavily on computers. For that reason, computer operations are usually an important aspect of an institution's internal control structure. In evaluating an institution's internal control structure and assessing control risk, control issues involving computer operations are significant and should receive considerable attention. The independent accountant needs to obtain an understanding of both the manual and the computerized aspects of an institution's systems as they relate to the institution's internal control structure. The independent accountant should consider matters such as—

- The extent to which computers are used for significant accounting applications.
- The complexity of the institution's computer operations, including whether outside service centers are used.
- The organizational structure for computer activities, including the extent to which on-line terminals and networks are used.
- The physical security controls over computer equipment.
- Controls over computer programming (for example, program changes and access to data files), operations, and systems.
- The availability of data. (Documents that are used to enter information into the computer for processing, certain computer files, and other evidential matter that may be required by the independent accountant may exist only for a short period or only in computer-readable form. In some computer systems, such as local area networks, input documents

may not exist at all, because information is entered directly into the system. An institution's data retention policies may require that the independent accountant specifically request that certain information be retained or that the independent accountant perform procedures at a time when the information is available.)

- The use of computer-assisted audit techniques to increase the efficiency of performing procedures. (Using computer-assisted audit techniques may also provide the independent accountant with an opportunity to apply certain procedures to an entire population of accounts or transactions. In addition, in some accounting systems, it may be difficult or impossible for the independent accountant to analyze certain data or test specific control procedures without computer assistance.)

3.15 The AICPA Auditing Procedure Study *Auditing in Common Computer Environments*, provides guidance to independent accountants when institutions use microcomputers, local area networks, end-user computing, data base management systems, or telecommunications in conjunction with their accounting systems. The Auditing Procedure Study identifies a number of electronic data processing technologies and software applications that may affect the financial statement audit, describes how these technologies and applications work, and discusses possible ramifications for the financial statement audit.

3.16 Computer operations may be performed solely by the institution, shared with others, or provided by an independent organization supplying specific data-processing services for a fee. SAS No. 70 provides guidance on the factors that an independent accountant should consider when auditing the financial statements of entities that use third-party organizations to process certain transactions.

3.17 The independent accountant should consider whether specialized skills are needed to consider the effect of computers on the audit, to understand the internal control structure policies and procedures, or to design and perform audit procedures. If specialized skills are needed, the independent accountant should seek the assistance of someone possessing such skills who may be either on the independent accountant's staff or an outside professional. If the use of such a professional is planned, the independent accountant should have sufficient computer-related knowledge to communicate the desired objectives to the computer professional, to evaluate whether the specific procedures will meet the independent accountant's objectives, and to evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned audit procedures.

3.18 System upgrades, conversions, and changes in technology have occurred with increasing frequency in the industry to accommodate the many changes in the nature and complexity of products and services offered, ongoing changes in accounting rules, continually evolving regulations, and mergers and acquisitions. Some system changes may affect the internal control structure. For example, merging institutions with incompatible computer systems can have a significant negative impact on the surviving institution's internal control structure. In addition to obtaining the understanding of ongoing or planned changes in processing controls that is necessary to plan the audit, the independent accountant may find it necessary to consider the effect of system changes on—

a. Controls over the accurate conversion of data to new or upgraded systems.

b. The effectiveness of data provided to perform analyses, such as those of the institution's performance versus its plan for asset-liability management.

c. The adequacy of the institution's disaster recovery plan and system.

3.19 SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), provides guidance on identifying and reporting conditions that relate to an institution's internal control structure over financial reporting observed during an audit of financial statements in accordance with GAAS. SAS No. 60 requires that "reportable conditions" that are observed during such an audit be communicated to the audit committee or to individuals with a level of authority and responsibility equivalent to that of an audit committee in organizations that do not have one.

3.20 Reportable conditions are matters coming to an auditor's attention that, in his or her judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of the internal control structure that could adversely affect the institution's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Such deficiencies may involve the internal control structure elements of (*a*) the control environment, (*b*) the accounting system, or (*c*) control procedures.

3.21 An appendix to SAS No. 60 includes a list of examples of reportable conditions.

Analytical Procedures

3.22 SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), provides guidance on the use of analytical procedures in audits of financial statements in accordance with GAAS and prescribes the use of analytical procedures in both the planning and review stages for such engagements. For planning purposes, such procedures focus on (*a*) enhancing the independent accountant's understanding of the institution's business and transactions and events that have occurred since the last financial statement audit and (*b*) identifying areas that may present specific risks relevant to the financial statement audit. The objective of analytical procedures is to identify unusual transactions and events, and amounts, ratios, and trends that might indicate matters that have financial statement and audit planning ramifications.

3.23 Analytical procedures used in planning the audit generally use data aggregated at a high level. The nature, extent, and timing of the procedures, which are based on the independent accountant's judgment, may vary widely depending on the size and complexity of the institution. The procedures may consist of reviewing changes in account balances from the prior year to the current year using the general ledger or a preliminary or unadjusted working trial balance. Alternatively, the procedures may involve an extensive analysis of quarterly financial statements, ratios, statistics, and budgeted amounts, including their relationship to performance of the industry as a whole. In either case, the analytical procedures, combined with the independent accountant's knowledge of the business, serve as a basis for additional inquiries and effective planning.

3.24 Ratios, operating statistics, and other analytical information that may be useful in assessing an institution's position relative to other similar institutions and to industry norms, as well as in identifying unusual relationships between data about the institution itself, are generally readily available. Ratios and statistics developed for use by management or regulators often can be effectively used by the independent accountant in performing analytical procedures for planning purposes. Many institutions disclose analytical information in their annual and quarterly reports. Other sources of information that may be useful for planning purposes are the institution's call reports and the disclosures made by publicly held institutions in accordance with the Securities and Exchange Commission's Industry Guide No. 3, *Statistical Disclosures by Bank Holding Companies*. The *Uniform Bank Performance Reports,* published by the FFIEC, and the *Annual Bank Operating Statistics*, published by the Federal Deposit Insurance Corporation (FDIC), contain industry data and statistics. There are also several sources of industry data published by private companies.

3.25 Analytical procedures involve the comparison of recorded amounts or ratios developed from recorded amounts with expectations developed by the independent accountant. Examples of analytical procedures that may be useful to independent accountants planning an audit of the financial statements of a bank or savings institution include comparison of account balances with budgeted and prior-period amounts as well as analysis of ratios that indicate relationships among elements of financial information within the period and relationships to similar information about other institutions. For overall review purposes, analytical procedures should focus on considering the adequacy of the evidence gathered in response to unusual or unexpected balances or relationships. The objective of the procedures is to help the independent accountant in assessing the conclusions reached and evaluating the overall financial statement presentation. Analytical procedures also may be used as substantive tests to identify potential misstatements. These procedures focus on comparing actual with expected balances and ratios and investigating and evaluating significant differences.

3.26 A number of the ratios that may be useful to the independent accountant in an audit of the financial statements of an institution are listed below with a brief description of the information they provide:

- *Investments to total assets*—measures the mix of earning assets
- *Loans to total assets*—measures the mix of earning assets
- *Investments by type divided by total investments*—measures the composition of investment portfolio
- *Loans to deposits*—indicates the funding sources for the loan base
- *Loans by type to total loans*—measures the composition of loan portfolio and of lending strategy and risk
- *Allowance for loan losses to total loans*—measures loan portfolio credit risk coverage
- *Loan loss recoveries to prior-year write-offs*—indicates write-off policy and measures recovery experience
- *Classified loans to total loans*—indicates asset quality
- *Investment income to average total securities*—measures investment portfolio yield
- *Allowance for loan losses to classified loans*—measures management's estimate of losses

- *Loan income to average net loans*—measures loan portfolio yield
- *Total interest expense to average total deposits*—measures costs of funds
- *Overhead to total revenue (net interest income plus noninterest income)*—measures operating efficiency
- *Net income to average total assets*—measures return on assets
- *Net income to average capital*—measures return on equity
- *Capital ratios*—measures financial strength
- *Noninterest income to total revenue (net interest income plus noninterest income)*—measures the extent of noninterest income
- *Liabilities to shareholders' equity*—measures the extent equity can cover creditors' claims in the event of liquidation

Using the Work of a Specialist

3.27 SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards,* vol. 1, AU sec. 336), provides guidance for independent accountants who use the work of a specialist in audits performed in accordance with GAAS. SAS No. 73 provides examples of situations that might require using the work of specialists and types of specialists being used, and guidance for when a specialist is related to the client.

3.28 SAS No. 73 applies whenever the independent accountant uses a specialist's work as evidential matter in performing substantive tests to evaluate material financial statement assertions, regardless of whether—

- Management engages or employs specialists.
- Management engages a specialist employed by the independent accountant's firm to provide advisory services.
- The independent accountant engages the specialist.

3.29 SAS No. 73 does not apply if a specialist employed by the independent accountant's firm participates in the audit. For example, if the independent accountant's firm employs an appraiser and decides to use that appraiser as part of the audit team to evaluate the carrying value of properties, SAS No. 73 would not apply. In such cases, the independent accountant should refer to SAS No. 22.

3.30 SAS No. 73 requires an independent accountant to evaluate the professional qualifications of the specialist to determine whether he or she possesses the necessary skill or knowledge. SAS No. 73 requires the independent accountant to consider the specialist's experience and the type of work under consideration. For example, if the independent accountant is using an appraisal of commercial real estate values in connection with the audit of a bank's financial statements, he or she will need to consider not only the appraiser's professional qualifications but also his or her experience with commercial real estate.

3.31 The independent accountant should also understand the nature and purpose of the specialist's work. In a number of cases, the specialist's work may have been prepared for another purpose (such as, an appraiser's report prepared for a loan origination). In these situations, the independent accountant should consider the appropriateness of using the specialist's work to evaluate financial statement assertions. SAS No. 73 acknowledges that, in some cases, an independent accountant may need to contact the specialist to determine whether the specialist is aware that his or her work will be used for corroborating the assertions in the financial statements.

3.32 SAS No. 73 does not preclude the independent accountant from using a specialist who has a relationship with the client, including situations in which the client has the ability to directly or indirectly control or significantly influence the specialist. The Statement does, however, require the independent accountant to evaluate the relationship and consider whether it might impair the specialist's objectivity. If the independent accountant concludes that the specialist's objectivity might be impaired, additional procedures should be performed, possibly including using the work of another specialist.

Processing of Transactions by Service Organizations

3.33 Paragraphs 6 through 21 of SAS No. 70 provide guidance on the user auditor's consideration of the effect of a service organization on the internal control structure of the user organization and availability of audit evidence. That guidance should be considered when planning and performing the audit of the financial statements of an institution that uses a service organization to process transactions (for example, using a mortgage banker to service mortgages).

Consideration of the Possibility of Material Misstatements

3.34 There are certain risks inherent in all financial statement audits. One such risk is the possibility that the financial statements are materially misstated as the result of errors and irregularities or illegal acts by clients. SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), provides guidance on the independent accountant's responsibility for the detection of errors and irregularities in an audit of financial statements performed in accordance with GAAS. SAS No. 53 describes factors that influence the independent accountant's ability to detect errors and irregularities and explains that the exercise of due care should give appropriate consideration to the possibility of errors and irregularities. It also provides guidance on the independent accountant's responsibility to communicate detected matters both within and outside the entity whose financial statements are being audited. Management, industry, or engagement characteristics that may be indicative of increased risk of possible material misstatements in an audit of the financial statements of an institution include those listed in paragraph 10 of SAS No. 53, as well as the following:

a. Noncompliance with laws and regulations (see chapter 2), including—
- Failure to meet regulatory capital requirements or otherwise adhere to capital plans
- Agreements, both formal and informal, between an institution and its regulators

b. Material changes in operations or operating performance, for example—
- Sudden change in management's asset/liability management strategies or activities

- Increased dependence on brokered deposits or short-term borrowings as a source of funds
- Significant changes in the volume of hedging or trading activities
- Increases in overhead ratios to levels that are significantly above industry averages
- Significant increases in non-earning assets
- Severe cost-cutting measures
- Declining net-interest spreads or related changes in interest-rate risk
- Increases in rates on deposits to levels that are significantly higher than those offered by competitors
- Sudden or rapid growth in assets or off-balance-sheet activities

c. Practices that fail to consider changing economic conditions, for example, overreliance on historical data in the evaluation of credit risk.

d. Material one-time transactions, particularly those that (1) account for a material portion of related income or otherwise indicate attempts to realize large, short-term benefits or (2) occur at or near the end of a reporting period. For example—
- High-volume purchases or sales of assets (such as mortgage servicing rights)
- Speculative or unusual off-balance-sheet transactions
- Sales of loans classified as held for investment
- Sales of debt securities classified as held-to-maturity

e. Highly complex or speculative transactions, such as those involving—
- Complex mortgage securities
- Investments in noninvestment-grade securities
- Complicated, multistep transactions involving real estate

f. Nontraditional or unusual loan transactions, for example—
- Loans with unusual, questionable, or inadequate collateral
- Loans outside the institution's normal lending area
- Poorly documented loans
- Loans where interest is paid from interest reserves
- Loans secured by collateral that has dramatically changed in value
- Significant concentrations of loans (that is, in one industry or geographical area or with one borrower or its related interests)
- Real estate venture loans that may need to be accounted for as equity investments
- A pattern of extension or modification of loan terms
- Lending activities inconsistent with management's stated policies

3.35 The independent accountant should also consider the potential for insider abuse—that is, actions by the institution's officers, directors, or major shareholders intended to benefit themselves or related parties without regard to potential effects on the institution. The potential for insider abuse is often associated with unusual or questionable loan transactions like those described above.

Developing an Overall Audit Plan

3.36 The independent accountant's overall judgment about the level of inherent risk in an engagement affects staffing, the extent of supervision, overall audit scope and strategy, and the degree of professional skepticism applied. As the above discussion underscores, banks and savings institutions are subject to certain risks that are less prevalent in commercial, industrial, and other nonfinancial businesses, and they operate in a particularly volatile and highly regulated environment. Accordingly, the independent accountant should consider staffing those areas of the engagement that involve relatively higher risk with personnel with appropriate relevant experience, providing more extensive supervision, and maintaining a heightened degree of professional skepticism.

3.37 ***Internal Audit Considerations.*** SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322), provides guidance on the independent accountant's consideration of the existence of an internal audit function in determining the nature, timing, and extent of auditing procedures to be performed, and on using internal auditors to provide direct assistance to the independent accountant in an audit of financial statements performed in accordance with GAAS.

3.38 ***Timing of the Audit.*** In audits of financial statements, independent accountants often determine that a significant number of audit procedures can be performed prior to the balance-sheet date. SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AICPA, *Professional Standards*, vol. 1, AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"), provides guidance concerning—

a. Factors to be considered before applying principal substantive tests to the details of particular asset or liability accounts as of a date that is prior to the balance-sheet date (an interim date).

b. Audit procedures to provide a reasonable basis for extending audit conclusions from such principal substantive tests from an interim date to the balance-sheet date (the remaining period).

c. Coordinating the timing of auditing procedures.

Compliance With Laws and Regulations

3.39 Paragraph 7 of SAS No. 22 states that, in planning the audit, the independent accountant should consider "matters affecting the industry in which the entity operates, such as economic conditions, *government regulations,* and changes in technology, as they relate to his audit [*emphasis added*]." In performing an audit of financial statements in accordance with GAAS, the independent accountant considers government regulations in light of how they might affect the financial statement assertions.

3.40 SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), prescribes the nature and extent of the independent accountant's consideration of the possibility of illegal acts by a client in an audit of financial statements in accordance with GAAS.

3.41 The term *illegal acts* refers to violations of laws or governmental regulations. Illegal acts vary considerably in their relation to the financial statements. The independent accountant's responsibility to detect and report misstatements resulting from illegal acts is dependent on the relationship between the law or regulation that is violated and the financial statements.

3.42 Some laws and regulations have a direct and possibly material effect on the determination of financial statement amounts. For example:

- Tax laws affect accruals and the amount recognized as expense in the accounting period.
- Certain laws and regulations place limits on the nature or amount of investments that institutions are permitted to hold. Such laws and regulations may affect the classification and valuation of assets.

3.43 Other laws and regulations relate more to an institution's operating aspects than to its financial and accounting aspects, and their effect on the financial statements is indirect. Examples of such laws and regulations include those related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment opportunities, and antitrust violations. Another example of such laws and regulations are those that require institutions to report certain financial transactions to governmental agencies. The indirect effect of violations of such laws and regulations is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality.

3.44 The ultimate responsibility for compliance with laws and regulations rests with management of the institution. Nonetheless, throughout the audit, the independent accountant should be aware of the possibility that illegal acts that could have a material effect on the institution's financial statements may have occurred. The independent accountant should design the audit to provide reasonable assurance of detecting misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts. If specific information comes to the independent accountant's attention that provides evidence of other possible illegal acts that could have a material indirect effect on the financial statements, the independent accountant should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred. However, because of the characteristics of illegal acts explained above, an audit conducted in accordance with GAAS provides no assurance that indirect-effect illegal acts will be detected or that any contingent liabilities that may result will be disclosed.

Going Concern Considerations

3.45 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), as amended, requires independent accountants to evaluate—as part of every financial statement audit—whether there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. The independent accountant's evaluation of an institution's ability to continue as a going concern may be one of the most complex and important portions of the audit. This section describes the unique issues that an independent accountant may encounter in evaluating an institution's ability to continue as a going concern.

3.46 Banks and savings institutions operate in a highly regulated environment. As a result, laws and regulations can have a significant effect on their operations. The enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 and the FDIC Improvement Act of 1991 dramatically changed the regulatory environment in the banking and thrift industries and imposed new regulatory capital requirements that are far more stringent than previous requirements. Chapter 2 includes a discussion of regulatory capital requirements.

3.47 In accordance with SAS No. 59, the independent accountant should consider whether there is substantial doubt about an institution's ability to continue as a going concern for a reasonable period of time in the following manner:

a. The independent accountant considers whether the results of procedures performed in planning, gathering evidential matter relative to the various audit objectives, and completing the audit identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

b. If the above considerations lead the independent accountant to believe that substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time, the independent accountant should obtain information about management's plans intended to mitigate the adverse effects of the conditions or events that gave rise to the doubt and assess the likelihood that such plans can be effectively implemented.

c. After evaluating management's plans, the independent accountant concludes whether he or she has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

3.48 SAS No. 59 states that it is not necessary to design audit procedures solely to identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the ability of an entity to continue as a going concern for a reasonable period of time. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose. The following are examples of procedures normally performed in audits of the financial statements of banks and savings institutions that may identify such conditions and events:

- Analytical procedures
- Review of subsequent events
- Review of compliance with the terms of debt and loan agreements
- Reading of minutes of meetings of the board of directors and important committees of the board
- Inquiry of an entity's legal counsel about litigation, claims, and assessments
- Confirmation with related and third parties of the details of arrangements to provide or maintain financial support
- Review of the financial strength and liquidity of the parent company, if applicable
- Review of reports of significant examinations and related communications between examiners and the institution
- Review of compliance with regulatory capital requirements

3.49 In performing such audit procedures, the independent accountant may identify information about certain conditions or events that, when considered in the aggregate, indicate that there could be substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time. The significance of such conditions and events will depend on the circumstances, and some may have significance only when viewed in conjunction with others. The following are examples of such conditions and events that may be encountered in audits of banks and savings institutions:

- Recurring operating losses
- Indications of strained liquidity
- Failure to meet minimum regulatory capital requirements or to adhere to the terms of an approved capital plan
- Concerns expressed or actions taken by regulatory authorities regarding alleged unsafe or unsound practices
- Indications of strained relationships between management and regulatory authorities

3.50 SAS No. 59 states that if, after considering management's plans, the independent accountant concludes that there is substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time, the independent accountant should consider the possible effects on the financial statements and the adequacy of the related disclosures. Some of the information that might be disclosed includes—

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time.
- The possible effects of such conditions and events.
- Management's evaluation of the significance of those conditions and events and any mitigating factors.
- Possible regulatory sanctions, including discontinuance of operations.
- Management's plans (including information about the institution's capital plan and relevant prospective financial information).
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities.

3.51 If, upon consideration of management's plans, the independent accountant concludes that substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time is alleviated, the independent accountant should consider the need for disclosure in the financial statements of the principal conditions and events that initially caused the independent accountant to believe there was substantial doubt. Disclosure should include the possible effects of such conditions and events and any mitigating factors, including management's plans.

3.52 If the independent accountant concludes that substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph (following the opinion paragraph) to reflect that conclusion. The independent accountant's decision about whether modification of the standard report is appropriate may depend also on—

- The institution's existing regulatory-capital position.
- The likelihood that the institution's regulatory-capital position will improve or deteriorate within the next twelve months.
- Whether the plan has been accepted by regulatory authorities.

- The independent accountant's assessment of the institution's ability to achieve its capital plan, if any.

3.53 Paragraph 18.13 discusses circumstances in which the independent accountant might disclaim an opinion.

3.54 The decision about the appropriate form of audit report to issue in particular circumstances is often a complex judgment that requires considerable professional experience. The independent accountant may have to communicate with the regulator to assist with his or her assessment. (Refer to chapter 2 for a discussion of required communications with regulators.) Chapter 18 includes an illustration of a report that includes such an explanatory paragraph.

Client Representations

3.55 SAS No. 19, *Client Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), requires that the independent accountant obtain written representations from management as part of a financial statement audit performed in accordance with GAAS and provides guidance concerning the representations ordinarily obtained. Such representations are part of the evidential matter the independent accountant obtains but are not a substitute for the application of auditing procedures. The specific written representations to be obtained depend on the circumstances of the engagement and the nature and basis of the presentation of the financial statements. Paragraph 4 of SAS No. 19 lists matters ordinarily included in management's representation letter. Additional representations specific to banks and savings institutions that may be obtained include the following:

- All regulatory examination reports, supervisory correspondence, and similar materials from applicable regulatory agencies (particularly communications concerning supervisory actions or noncompliance with, or deficiencies in, rules and regulations or supervisory actions) have been provided to the independent accountant.
- The classification of securities between held-to-maturity, available-for-sale, or trading categories accurately reflects management's ability and intent.
- The methodology for determining fair value disclosures is based on reasonable assumptions.
- Adequate disclosure has been made of the status of the institution's capital plan filed with regulators, if applicable, and management believes it is in compliance with any formal agreements or orders in any memorandum of understanding or cease-and-desist order.
- Contingent assets and liabilities have been adequately disclosed in the financial statements.
- Related party transactions have been entered into in compliance with existing regulations.
- Adequate provision has been made for any losses, costs, or expenses that may be incurred on securities, loans, or leases and real estate as of the balance-sheet date.
- Other than temporary declines in the value of investment securities have been properly recognized in the financial statements.
- Commitments to purchase or sell securities under forward-placement, financial-futures contracts and standby commitments have been adequately disclosed in the financial statements.

- Sales with recourse have been adequately disclosed in the financial statements.
- Proper disclosure has been made regarding the nature, terms, and credit risk of financial instruments with off-balance-sheet risk.
- No transactions or activities are planned that would result in any recapture of the base-year, tax-basis bad debt reserves.
- Proper disclosure has been made regarding financial instruments with (*a*) significant off-balance-sheet risk and (*b*) significant individual or group concentrations of credit risk.

Information Other Than Financial Statements

3.56 An institution may publish various documents that contain information in addition to audited financial statements and the independent auditor's report thereon. SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), provides guidance for the independent accountant's consideration of such other information included in such documents.

3.57 In some circumstances, an independent accountant submits to the client or others a document that contains information in addition to the client's basic financial statements and the auditor's report thereon. Guidance on the form and content of such reporting is provided in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents,* and SAS No. 52, *Omnibus Statement on Auditing Standards—1987* (collectively, AICPA, *Professional Standards,* vol. 1, AU sec. 551).

3.58 SAS No. 52 also provides guidance on the nature of procedures to be applied to supplementary information required by the FASB and describes the circumstances that would require the auditor to report such information (see AICPA, *Professional Standards*, vol. 1, AU sec. 558, "Required Supplementary Information").

Chapter 4
Cash and Cash Equivalents

Introduction

4.01 Cash and cash equivalents include cash items in the process of collection (CIPC), deposits with other banks or savings institutions, balances with Federal Reserve Banks or Federal Home Loan Banks (FHLBs), and cash and cash equivalents on hand.

Cash Items in the Process of Collection and Cash Equivalents

4.02 CIPC includes drafts on other depository institutions that have been deposited but have not cleared, matured instruments (such as coupons and bonds), and other matured items temporarily held pending their liquidation. Such assets are received with deposits and other customer transactions. CIPC are eventually cleared through local clearinghouses, correspondent institutions (correspondents), or a Federal Reserve Bank. Collection of these items generally takes between one and five business days. Cash equivalents are short-term, highly liquid investments that are both readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates, for example, short-term certificates of deposit (CDs) issued by other federally insured financial institutions.

Deposits With Other Depository Institutions

4.03 Correspondents are depository institutions that hold the account balances of other banks or savings institutions and provide services to those institutions, such as check collection and item processing. Such accounts are generally called "due from banks" and are maintained by the depositors as a means of more efficient check clearing or to compensate the correspondent for other services provided to the depositor. Institutions that engage in international banking may maintain deposits with foreign depository institutions for the same reasons.

Balances With Federal Reserve Banks and Federal Home Loan Banks

4.04 Federal regulations require institutions to set aside specified amounts of cash as reserves against transaction and time deposits. These reserves may be held as vault cash, in a noninterest-bearing account with a district Federal Reserve Bank or FHLB, or as deposits with correspondents. Though one objective of reserve requirements is to safeguard liquidity in the banking system, institutions do not look to their reserves as a primary source of liquidity, because regulations permit their depletion for only short periods and in limited circumstances. Rather, reserves are a primary tool of the Board of Governors of the Federal Reserve System (FRB) to effect monetary policy: by increasing or decreasing reserve requirements, the FRB can expand or contract the money supply. Banks and savings institutions also may use a Federal Reserve Bank as a correspondent bank.

Cash on Hand

4.05 Cash on hand consists primarily of coin and currency in vaults, in automated teller machines (ATMs), and maintained by tellers to meet customers' requests. Cash on hand generally represents a small percentage of an institution's cash.

Accounting and Financial Reporting

4.06 Cash and cash equivalents are generally presented as the first item in the statement of financial condition. Generally, interest-bearing deposits with other depository institutions—domestic and foreign—should be disclosed separately. Restrictions on the use or availability of certain cash balances, such as deposits with a Federal Reserve Bank or FHLB to meet reserve requirements or deposits under formal compensating balance agreements, should be disclosed in the financial statements.

4.07 Overdrafts of correspondents or other demand deposit accounts that represent borrowings rather than outstanding drafts should be reclassified as liabilities, unless the depositors have other accounts at the same depository institution for which there is the right of setoff. Balances due to and due from a single depository institution, also called reciprocal balances, should also be offset if a right of setoff exists. Financial Accounting Standards Board (FASB) Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, defines right of setoff and specifies conditions that must be met to have that right.

4.08 FASB Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments*, requires the disclosure of fair values of financial instruments for which it is practicable to estimate fair value. The carrying amount of items classified as cash and cash equivalents generally approximates fair value because of the relatively short period of time between the origination of the instruments and their expected realization.

Classification of Cash Flows

4.09 FASB Statement No. 95, *Statement of Cash Flows*, classifies cash receipts and disbursements into three broad categories: operating cash flows, investing cash flows, and financing cash flows.

4.10 FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*, amended FASB Statement No. 95 by providing, among other things, that cash receipts and cash payments resulting from purchases and sales of securities are to be classified as operating cash flows if the securities are carried at market value in a trading account. FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, amended FASB Statement No. 102 to require that cash flows from purchases, sales, and maturities of available-for-sale securities be classified as cash flows from investing activities and reported gross in the statement of cash flows. Similarly, paragraph 9 of FASB Statement No. 102 requires that cash receipts and cash payments that result from loans originated or purchased specifically for resale are also to be classified as operating cash flows if such loans are carried at market value or at the lower of cost or market value. In applying FASB Statement No. 102 for the direct method, gross cash receipts and cash payments from these sources should be reported separately as operating cash flows. If the indirect method is used, only the net increases or decreases in these loans and securities should be reported in reconciling net income to the net cash flow from operating activities.

4.11 Cash flows from investing and financing activities must generally be reported on the basis of gross cash receipts and gross cash disbursements. However, FASB Statement No. 95 permits the net basis of reporting for the following:

- Cash and cash equivalents.
- Items for which turnover is quick, amounts are large, and maturity is short. These items are limited to those with an original maturity when purchased of three months or less, such as—
  - Investment securities not included in cash equivalents.
  - Loans (including demand loans and credit-card loans).
  - CDs.
  - Borrowings.
- Items for which the institution is substantively holding, receiving, or disbursing cash on behalf of its customers, such as—
  - Demand deposits.
  - NOW and SuperNOW accounts.
  - Savings deposits.
  - Money-market-deposit accounts.
  - Mortgage escrow funds.
  - Collections and remittances on loans serviced for others.

4.12 FASB Statement No. 104, *Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions*, amended FASB Statement No. 95 to permit financial institutions to report net cash receipts and cash payments for (*a*) deposits placed with other financial institutions and withdrawals of those deposits, (*b*) time deposits (CDs) accepted and repayments of those deposits, and (*c*) loans originated and principal collections on such loans. FASB Statement No. 104 also provides that cash flows from futures contracts, forward contracts, option contracts, or swap contracts that are accounted for as hedges of identifiable transactions or events, including anticipatory hedges, may be classified in the same category as the cash flows from the items being hedged provided that accounting policy is disclosed.

4.13 Summarized below are some typical investing and financing cash flows for a bank or savings institution.[1]

Investing Activities

Cash Inflows	*Cash Outflows*
Net loan principal payments	Net loan originations
Loan sale proceeds	Loan purchases
Security sale and maturity proceeds (disclose separately for held-to-maturity securities and available-for-sale securities)	Security purchases (disclose separately for held-to-maturity securities and available-for-sale securities)

[1] Paragraph 21 of FASB Statement No. 95 says that operating activities include all transactions and other events that are not defined as investing or financing activities in paragraphs 15 through 20 of the Statement.

Cash Inflows	*Cash Outflows*
Real estate sale proceeds	Investment in real estate held for development
Net deposits withdrawn from other financial institutions	Net deposits placed with other financial institutions
Sales of loan servicing rights	Purchases of loan servicing rights
Net decrease in reverse repos	Net increase in reverse repos

Financing Activities

Cash Inflows	*Cash Outflows*
Net increase in mortgage escrow deposits	Net decrease in mortgage escrow deposits
Net CDs issued	Net CDs matured
Net increase in other deposit accounts	Net decrease in other deposit accounts
FHLB advances and other borrowings proceeds	Repayment of FHLB advances and other borrowings
Net increase in short-term borrowings (original maturity of three months or less)	Net decrease in short-term borrowings (original maturity of three months or less)
Proceeds from the sale of common stock or other equity instruments	Reacquisition of equity instruments (for example, purchase of treasury stock)
	Dividends and other cash distributions to stockholders
Net increase in long-term borrowings	Net decrease in long-term borrowings
Net increase in repos and dollar repos	Net decrease in repos and dollar repos

4.14 ***Noncash Investing and Financing Activities.*** Investing and financing activities that are partially or fully noncash transactions must be reported in a related disclosure either (*a*) in narrative form in the notes to the financial statements or (*b*) in a schedule. Examples of noncash investing and financing activities for banks and savings institutions include—

- Originating a mortgage loan to finance the sale of foreclosed real estate or real estate held for development.
- Acquiring a real estate property through, or in lieu of, foreclosure of the related loan.
- Converting mortgage loans into mortgage-backed securities (commonly referred to as "securitizing" loans).
- Selling or purchasing branch offices when the buyer assumes deposit liabilities in exchange for loans and other assets received from the seller, in which case only the cash paid, net of cash acquired or received, should be reported as a cash outflow or inflow.
- Converting debt to equity.
- Acquiring assets under capital leases.
- Acquiring another institution using the purchase method of accounting, in which case only the cash paid in the acquisition, net of cash acquired, should be reported as a cash outflow from an investing act-

ivity and information concerning the fair value of assets acquired and liabilities assumed should be presented in the supplemental disclosure of noncash activities.

4.15 ***Definition of "Cash and Cash Equivalents."*** The beginning and ending amounts of cash and cash equivalents in the statement of cash flows should agree with the amount shown for similarly titled line items or subtotals in the balance sheet. Cash is defined to include currency on hand, demand deposits with financial institutions, and other deposit accounts with similar characteristics (that is, the ability to deposit additional funds at any time and withdraw funds at any time without prior notice or penalty). Cash equivalents are defined in FASB Statement No. 95 to include instruments that are both—

a. Short-term instruments near enough to maturity such that there is an insignificant risk of changes in market value due to changing interest rates. Short-term generally means an original maturity of three months or less. Original maturity to the purchaser is measured from the acquisition date to the maturity date. For example, a three-year U.S. Treasury note purchased three months before maturity would be a cash equivalent, whereas the same note purchased one year before maturity would not be a cash equivalent.

b. Highly liquid instruments readily convertible to known amounts of cash.

4.16 Only instruments that meet both of the above criteria and are used as part of an institution's cash-management activities should be included in cash equivalents. For example, U.S. Treasury bills purchased for an investment account would be part of the institution's investing activities (not cash-management activities) and would therefore be excluded from cash equivalents. Common examples of cash equivalents include ninety-day U.S. Treasury bills and notes, commercial paper, CDs, money-market funds, and federal funds sold.[2]

4.17 Because of the flexibility in classification, FASB Statement No. 95 requires disclosure of the policy used to classify items as cash equivalents. This disclosure is generally included in the accounting policy footnote. A change in this policy is defined as a change in accounting principle that requires a restatement of prior years' financial statements presented for comparative purposes.[3]

Auditing

Objectives

4.18 The primary audit objectives for cash are to obtain reasonable assurance that—

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[2] The applicability of FASB Statement No. 115 to such items is based on whether they are securities (as defined) regardless of whether they are considered cash equivalents.

[3] For purposes of the illustrative consolidated statements of cash flows presented in chapter 19, cash and cash equivalents were defined as those amounts included in the balance-sheet caption "cash and due from banks." For purposes of the illustrative statement of cash flows presented in appendix C of FASB Statement No. 95 (as amended by FASB Statement No. 102), cash and cash equivalents were defined to include cash on hand, amounts due from banks, and federal funds sold. Both policies conform with the requirements of FASB Statement No. 95.

a. Recorded balances exist and are owned by the institution.

b. Recorded balances are complete and stated at realizable amounts.

c. Balances are properly presented in the financial statements.

d. Restrictions on the availability or use of cash are appropriately identified and disclosed.

e. Cash receipts, disbursements, and transfers between accounts are recorded in the proper period.

Planning

4.19 Cash and cash equivalents are generally negotiable, involve large volumes of transactions, and affect a large number of financial statement accounts. Chapter 3 discusses the independent accountant's responsibility to consider the internal control structure and to detect and report misstatements resulting from illegal acts (such as defalcations of cash).

Internal Control Structure Over Financial Reporting and Possible Tests of Controls[4]

4.20 Because of the negotiability of the items included in cash, the large volume of activity in cash accounts, and the large number of accounts affected by cash transactions, the effectiveness of the internal control structure in this area is an important factor in audit planning. The internal control structure over financial reporting and possible tests of controls related to the payments function, including wire transfers, are discussed in chapter 11. Examples of internal control structure policies and procedures for cash balances include the following:

- Currency and coins are periodically counted and are reconciled to recorded amounts on a timely basis.
- Surprise counts of teller cash funds, vault cash, and cash items are performed periodically by persons other than those with related day-to-day responsibility.
- Tellers have exclusive access to and custody of their respective cash on hand.
- Access to night depositories (including ATM depositories) is under dual control (the control of more than one person), and at least two persons are present when the contents of depositories are removed, counted, listed, or otherwise processed.
- Cash transaction items are reviewed daily for propriety by an officer or a supervisory employee other than the custodian of the items.

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[4] In December 1995, the Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). SAS No. 78 revises the definition and description of internal control contained in the SASs to recognize the definition and description contained in *Internal Control—Integrated Framework* published by the Committee of Sponsoring Organizations of the Treadway Commission. SAS No. 78 is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted.

In conjunction with SAS No. 78, the ASB issued Statement on Standards for Attestation Engagements (SSAE) No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2* (AICPA, *Professional Standards*, vol. 1, AT sec. 400). SSAE No. 6 conforms the description of elements of an entity's internal control to the components of internal control contained in SAS No. 78 and the *Internal Control—Integrated Framework*. SSAE No. 6 is effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, with earlier application permitted.

- Each of the functions of draft issuance, register maintenance, and reconciliation is performed by a different employee.
- Confirmation requests received from banks or savings institutions, supervisory examiners, and other parties are processed by an employee who does not also reconcile the subject account.
- Controls exist over access to and execution of official and certified checks.
- Cash and coin-counting equipment are periodically tested for accuracy.
- Currency that is mutilated or identified as counterfeit is segregated and reported.
- Tellers' cash on hand is limited and the replenishment of such funds is documented and reviewed by another employee.
- Physical storage of currency and coins is adequate to reasonably protect against theft or other misappropriation.
- Vault cash is under the control of more than one person.
- Procedures exist for the credit evaluation of correspondent banking relationships.
- Records of ATM transactions are reconciled to their recording in books of entry on a daily basis.

4.21 The independent accountant may decide to perform procedures to obtain evidential matter about the effectiveness of both the design and operation of internal control structure policies and procedures over financial reporting of cash to support a lower level of assessed control risk. Examples of tests of controls that might be considered include—

- Observing that adequate segregation of duties exists with respect to the handling and reconciliation of cash.
- Testing documentation of surprise cash counts of teller, vault, ATM, and other cash on hand to determine that they are performed periodically and in accordance with the institution's policies.
- Inquiring about and observing maintenance of control over mail receipts and supplies of consigned items.
- Inspecting and testing reconciliations to determine that they are performed and reviewed in a timely manner.

4.22 Possible tests of internal control policies and procedures related to electronic funds transfers are discussed in chapter 11.

Substantive Tests

4.23 The independent accountant should determine the nature, timing, and extent of substantive tests based on an assessment of both inherent risk and control risk. Substantive tests that the independent accountant should consider include—

- Counting cash and comparing the balances with tellers' records.
- Testing tellers' records for mathematical accuracy.
- Testing reconciliations between recorded balances of cash due from correspondents and statements received from correspondents.
- Reviewing cash-over-and-short summaries.
- Reconciling and reviewing the cutoff of interbank transfers.

- Testing reconciliations of subsidiary ledgers to the general ledger.
- Testing the propriety of authorized accounts and signatures.
- Reviewing the composition of suspense accounts, especially noting the recurring use and aging of reconciling items and any failure or inability to reconcile the cash account.
- Confirming account balances with, and reviewing the creditworthiness of, correspondents.
- Confirming consigned items with consignors.
- Reviewing cash records for unusual transactions or adjustments.
- Testing the propriety of due to and due from accounts set off in the balance sheet.
- Testing fair value disclosures.

Chapter 5

Investments in Debt and Equity Securities

Introduction

5.01 Banks and savings institutions acquire securities for various purposes. In addition to providing a source of income through investment or resale, securities are used to manage interest-rate and liquidity risk as part of an institution's overall asset/liability management strategies (see chapter 1). They are also used in certain collateralized transactions. The most common securities acquired by depository institutions are described below.

U.S. Government and Agency Obligations

5.02 The Department of the Treasury, as fiscal agent for the United States, routinely sells federal government debt securities called *treasuries*. Backed by the full faith and credit of the United States, treasuries are virtually free of credit risk. Because they are traded actively in a large secondary market, treasuries are highly liquid. The income they provide generally is exempt from state and local taxes. Accordingly, treasuries are used by institutions as a primary source of liquidity.

5.03 U.S. Treasury bills (T-bills) are the shortest term obligations, having original maturities of one year or less. T-bills are sold at a discount from their face value; income to T-bill investors is the difference between the purchase price and the face value. U.S. Treasury notes and bonds (T-notes and T-bonds, respectively) are longer-term obligations that earn interest paid in semiannual coupon payments. T-notes have original maturities between one and ten years; T-bonds have maturities of ten years or longer.

5.04 The debt of U.S. government agencies (such as the Government National Mortgage Association, or Ginnie Mae) and government-sponsored enterprises (such as the Federal Home Loan Mortgage Corporation, or Freddie Mac) trades at yields slightly higher than treasury yields. The agencies and government-sponsored enterprises (GSEs) issue debentures, notes, and other debt securities having a wide variety of maturities and other features. Unlike agency debt, GSE debt is not secured by the full faith and credit of the United States. However, because the GSEs play a vital role in the nation's financial markets, many believe the Department of the Treasury would intervene before a GSE could default on its debt. Accordingly, GSE debt is perceived to have minimal credit risk.

Municipal Obligations

5.05 State and local governments and their agencies (such as housing, school, or sewer authorities) issue notes and bonds of various maturities. Many municipal bonds are callable: they may be redeemed by the municipality before the scheduled maturity date. Tax anticipation notes—so named under the expectation that they will be repaid with tax receipts—generally mature within one year and are usually purchased directly from the government at a negotiated price. Revenue and bond anticipation notes are similarly issued and retired with certain expected revenues or proceeds from the expected sale of bonds. Municipal bonds may be either general obligation (that is, backed by the full taxing authority of the issuer) or limited obligation (that is, used to finance specific long-term public projects, such as building a school). Municipal bonds are purchased through a competitive bidding process or in the secondary market.

5.06 Municipal obligations vary significantly in risk. Credit quality depends heavily on the ability and willingness of the municipality to service its debt or the profitability of the particular project being financed. Liquidity also varies—some municipal obligations are traded actively; others are traded only in thin markets. Most municipal obligations are exempt from taxes in the municipality of issue; their exemption from federal income taxes depends on the extent to which they benefit private parties rather than the public. (See paragraph 14.09 for additional discussion of tax-exempt income.)

Asset-Backed Securities (ABSs)

5.07 Asset-backed securities (ABSs) are sometimes referred to as derivative securities in that they are repaid with cash flows derived from other financial assets (such as mortgage loans or credit-card receivables).[1] ABSs provide a great level of liquidity to financial markets, allow for a wide variety of innovative products, and, because they often involve incrementally more risk, offer better yields than treasuries.

5.08 ABSs are highly versatile because cash flows from the underlying assets can be reconfigured through any number of structures for repayment to ABS investors. ABSs allow the issuer to enhance the marketability of the underlying assets, for example, by spreading liquidity and credit risk across broad pools, or by providing a higher yield to those investors willing to accept a higher concentration of the risks associated with specific cash flows from the collateral.

5.09 This chapter focuses on ABSs from the perspective of the security holder. Chapters 8 and 13 discuss matters unique to depository institutions that issue ABSs.

5.10 A given ABS structure involves any number of investment classes (or tranches) with various degrees of risk and reward. Among other common characteristics, ABSs—

- Are issued by both governmental and private issuers, including banks and savings institutions.
- Generally include some form of credit enhancement to limit the credit risk of the underlying assets. For example, an issuer or third party may guarantee that the ABS principal and interest will be repaid as scheduled regardless of whether cash is received from payments on the underlying collateral.
- Are often issued in book-entry form. That is, no physical certificates change hands; rather, ownership is recorded on the investor's account.

5.11 The largest volumes of ABSs issued are backed by real estate mortgage loans (mortgages) and are called mortgage-backed securities (MBSs).

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[1] ABSs do not meet the definition of *derivative financial instrument* for the purposes of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*. Paragraph 5 of that Statement defines a derivative financial instrument as "a futures, forward, swap, or option contract, or other financial instrument with similar characteristics." For purposes of this Guide, *derivative* (unless otherwise modified) is used to denote both ABSs and off-balance-sheet instruments, which are primarily addressed in chapter 15.

Other types of collateral that have been used in ABS issuances include credit-card receivables, treasuries, car loans, recreational vehicle loans, and mobile home loans. MBSs and other mortgage derivatives are discussed below to provide examples of risk characteristics and other matters that may be encountered with various forms of ABSs and their collateral.

5.12 ***Mortgage-Backed Securities.*** The simplest form of ABS is the basic (or *plain vanilla*) MBS, created by pooling a group of similar mortgages. Most MBSs are issued with a stated minimum principal amount and a stated interest rate and represent a pro rata share in the principal and interest cash flows to be received as the underlying mortgages are repaid by the mortgagors. The mortgages underlying the issuance typically have—

a. The same type of collateral, such as single-family real estate.

b. Fixed or adjustable interest rates within a specified range.

c. Maturities within a specified range.

5.13 Because repayment of MBSs is contingent on repayment of the underlying collateral, the risk characteristics of specific MBS issuances are driven by the risk characteristics of the collateral. For example, underlying mortgages insured by the Federal Housing Administration (FHA) would typically involve less credit risk than unguaranteed conventional mortgages. A credit enhancement by the issuer would further reduce credit risk. Again, because ownership of a plain vanilla MBS represents ownership in a pro rata share in the underlying principal and interest payments, the risks of the security are generally the same as those for the collateral.

5.14 ***More Complex MBS Structures.*** However, more complex MBS structures—called mortgage derivative securities or mortgage derivatives—concentrate or dilute risk to create a range of possible investments with unique risks and rewards. As described below, one must understand the structure and nature of a specific mortgage derivative to understand the related risks.

5.15 *Credit risk.* To make a particular issuance of MBS more attractive to potential investors, the credit risk associated with mortgages underlying MBS is generally reduced by the issuer or third party through some form of *credit enhancement*, such as—

a. A letter of credit.

b. Guarantee of scheduled principal or interest payments, often achieved through a transaction with a federal agency such as Ginnie Mae or a GSE such as Freddie Mac.

c. Insurance of all or a portion of scheduled principal and interest payments through insurance of the pool by a private insurer.

d. Overcollateralization of the issuance, where cash flows from the excess collateral are used to make up for delinquent collateral payments.

e. A senior/subordinated (senior/sub) structure, in which one group of investors holds a subordinated interest in the pool by accepting all or a large portion of the related credit risk in return for a greater yield.

5.16 The degree of protection from credit risk offered by the various types of credit enhancement must be considered in relation to the characteristics of the collateral and, therefore, is unique to each security. Further, when credit risk is addressed through a credit enhancement, the security holder is still at risk that the third-party guarantor or private insurer could default on its responsibility. (The risk that another party to a transaction will default on its obligations under the transaction is referred to as *counterparty risk.*) Many MBS issuances carry credit ratings assigned by an independent rating agency.

5.17 *Interest-rate risk and prepayment risk.* The overall return—or yield—earned on a mortgage depends on the amount of interest earned over the life of the loan and the amortization of any premium or discount. Mortgage yields, therefore, are highly sensitive to the fact that most mortgages can be repaid before their scheduled maturity date without penalty. Although the owner of a mortgage receives the full amount of principal when prepaid, the interest income that would have been earned during the remaining period to maturity—net of any discount or premium amortization—is lost.

5.18 As with individual mortgages, the actual maturities and yields of MBSs depend on when the underlying mortgage principal and interest are repaid. If market interest rates fall below a mortgage's contractual interest rate, it is generally to the borrower's advantage to prepay the existing loan and obtain new financing at the new, lower rate. Accordingly, prepayments may be estimated to predict and account for the yield on MBSs.

5.19 In addition to changes in interest rates, actual mortgage prepayments depend on other factors such as loan types and maturities, the geographical location of the related properties (and associated regional economies), seasonality, age and mobility of borrowers, and whether the loans are assumable (as are certain loans insured by the FHA or guaranteed by the Department of Veterans' Affairs).

5.20 Some MBSs are backed by adjustable-rate mortgages (ARMs). Interest rates on ARMs change periodically based on an independent factor plus an interest-rate spread, which is expressed as a specified percentage (1 percent, also referred to as one *point*) or one one-hundredth of a percentage (.01 percent, also referred to as one *basis point*). For example, an ARM might carry a rate that changes every six months based on the average rate on one-year treasuries plus two points. Annual increases in an ARM's interest rate are generally capped, as are total interest-rate increases over the life of the loan.

5.21 While yields on ARMs tend to follow increases in prevailing interest rates, they also follow interest rate declines. This, and the fact that many ARMs are often issued with *teaser* rates that are significantly below market rates as a way to attract borrowers, make it more difficult to predict the overall risk of investments in ARM MBSs. The frequency of interest-rate adjustments, the index, the initial interest rate, and the annual and lifetime caps all should be considered. For example, credit risk may be higher for ARM MBSs than for fixed-rate MBSs because borrowers' payments increase when interest rates are adjusted upward.

5.22 Changes in the indexed rates of certain ARMs lag behind changes in prevailing rates. When interest rates are falling, therefore, adjustable-rate MBSs generally trade at a premium, although frequently they are prepaid as borrowers seek to lock in lower fixed rates. Conversely, when interest rates are rising, adjustable-rate MBSs generally trade at a discount.

5.23 ***Other Mortgage Derivatives.*** Other mortgage-derivative securities add layers of complexity to the security structure to create investment classes that meet the needs of and are attractive to various potential investors. Security holders find certain investment classes attractive because they can purchase the cash flows they desire most, or can synthetically create a security with the desired interest rate and prepayment characteristics. As discussed above, MBSs offer pro rata shares in principal and interest cash flows with stated principal amounts and interest rates, and subject to credit, prepayment, and other risks. Mortgage derivatives are used to further restructure the cash flows and risks so that investment classes may be offered that feature—

- Different anticipated maturities.
- A single final payment rather than monthly installments (called a zero-coupon class).
- Floating interest rates.
- Repayment on a specified schedule, unless mortgage prepayments go outside a prescribed range (called a *planned amortization class* or PAC).
- Protection against faster—but not slower—prepayments (called a *targeted amortization class*, or TAC).
- Rights to interest cash flows only, called *interest-only securities* (IOs), or to principal cash flows only, called *principal-only securities* (POs).
- Rights only to those cash flows remaining after all other classes have been repaid (a *residual interest* or *residual).*

5.24 These and other specialized classes—and the fact that many mortgage derivatives use pools of MBSs rather than pools of mortgages as collateral—make analysis of investments in mortgage derivatives complex. Accordingly, such instruments could expose an institution to substantial risk if not effectively understood or managed by the institution and thereby increase audit risk.

5.25 Two common forms of multiclass mortgage derivatives are collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs). CMOs are bonds secured by (and repaid with) the cash flows from collateral MBSs or mortgages and generally involve some form of credit enhancement. The collateral is generally transferred to a special-purpose entity, which may be organized as a trust, a corporation, or a partnership. The special-purpose entity then becomes the issuer of the CMO. Accordingly, a security holder may invest in a CMO in equity form (for example, trust interests, stock, and partnership interests) or nonequity form (for example, participating debt securities). REMICs are a form of CMO specially designated for federal income tax purposes so that the related income is taxed only once (to the security holder). (See chapter 14.)

5.26 The guiding principle behind structuring a mortgage derivative or other ABS is that, under all possible circumstances, the cash flows from the collateral must be sufficient to repay the investment classes (as contractually defined) without an overage or shortage in cash flows. For example, under any interest-rate scenario, the collateral cash flows to all security holders will correspond to their contractual rights. Accordingly, understanding the risks associated with a particular tranche of a mortgage derivative or other ABS often requires an understanding of the security structure, as documented in the offering document and related literature.

5.27 A discussion of the risks associated with every possible form of mortgage derivative or other ABS is beyond the scope of this Guide. However, a basic understanding of the relationship between interest and principal cash flows, in addition to an understanding of related risks (such as credit risk), are needed to analyze investments in mortgage derivatives. The discussion below uses IOs, POs, and residuals as examples of ABS classes for this purpose. The discussion of the senior/sub structure used in some issuances also highlights the importance of understanding the structure and the form of credit enhancement when evaluating an investment in mortgage derivatives or other ABSs.

5.28 Investment classes that are focused on interest cash flows (interest classes), such as mortgage derivative IOs, are extremely interest-rate sensitive and, therefore, carry the risk that the security holder's entire recorded investment could be lost. Investment classes weighted toward principal cash flows (principal classes), such as mortgage-derivative POs, also carry special risks. The discussion below of related risk concepts can be applied to various other investments in mortgage derivatives or other ABSs.

5.29 *Interest classes and IOs.* Interest classes receive all, or substantially all, of the interest cash flows from the underlying collateral mortgages. Accordingly, they have been found to be useful vehicles for managing the interest-rate risk inherent in mortgage portfolios, since prepayments cause the value of IOs to move in the opposite direction from that of mortgages and traditional fixed-income securities. However, because of the sensitivity of IOs to interest rates, the recorded investment in an IO may be lost if actual prepayments are higher than anticipated.

5.30 Changes in the prices (and, therefore, the values) of mortgage derivatives depend largely on whether collateral interest rates are above or below prevailing interest rates. A mortgage will trade at a discount (a discount mortgage) when it carries an interest rate lower than prevailing interest rates. A mortgage that carries an interest rate above prevailing rates will trade at a premium (a premium mortgage).

5.31 An IO backed by a pool of premium mortgages may be a more useful tool for controlling interest-rate risk than one backed by a pool of discount mortgages, as it shows greater appreciation in value when interest rates increase and does not suffer as significant a decrease in value when interest rates fall. Falling interest rates generally result in greater prepayments. Accordingly, the cash generated from an IO over its life usually decreases because interest is earned on a smaller remaining principal balance. Although the discounting of the stream of interest receipts at a lower interest rate increases the present value of each future dollar of interest, the negative effect of increased prepayments generally outweighs the positive discounting effect, and, therefore, the fair value of the IO generally declines. IOs generally increase in value in a rising rate environment because as prepayments slow, the related mortgage principal balance remains outstanding for a longer period, and, therefore, interest is earned for a longer period (although the present value of each of those future dollars is reduced by the higher discount rate).

5.32 *Principal classes and POs.* Principal classes are often issued at deep discounts from the contractual principal amount because the security holder receives no interest. In contrast to zero-coupon bonds, whose entire principal amount is paid at maturity, the principal amount of POs is paid periodically according to repayment of the underlying mortgage principal. If the security holder has the ability to hold the PO to maturity, only credit risk or counterparty default would prevent ultimate recovery of the recorded investment. The fair value of a PO is also dependent on the effects of prepayments and discounting, both of which are dependent on interest rates.

5.33 The fair value of a PO tends to increase as prepayments accelerate, because the security holder receives the return of principal more quickly. Conversely, as prepayments slow, the value of the PO tends to decline. A PO backed by discount mortgages tends to appreciate more as interest rates fall than would a PO backed by premium mortgages. However, when interest rates rise, a PO backed by discount mortgages would not decline in value as much as a PO backed by premium mortgages. The difference in fair values reflects the relationship between prepayment rates and the stated interest rates on the collateral backing the POs. Prepayments on discount POs are generally significantly lower than prepayments on premium POs. As interest rates decline, prepayments on both types of PO will accelerate. However, prepayments on premium POs do not increase as much, because prepayments on these instruments are usually already at a high level. Conversely, when interest rates rise, prepayments on underlying discount mortgages do not slow significantly, because they are usually already at a relatively low level, but prepayments on underlying premium mortgages decline sharply.

5.34 A decline or increase in interest rates similarly causes the present value of cash flows from POs to increase or decrease, respectively, because of related changes in the discount rate used to determine the present value of any future cash flows.

5.35 Because POs generally increase in value in response to declining interest rates, they are sometimes used to manage the interest-rate risk associated with investments in mortgage servicing rights, CMO or REMIC residuals, and IOs. However, institutions in liability-sensitive positions (that is, institutions whose liabilities will reprice more quickly than their assets) would be negatively affected by an increase in interest rates, and, therefore, the use of POs to manage the interest-rate risk of such assets may be counterproductive because such a strategy may increase the institution's overall exposure to interest-rate risk.

5.36 *Residual classes.* From a legal perspective, residuals represent an ownership interest in the underlying collateral, subject to the first lien and indenture of the other security holders. Residuals entitle the holder to the excess, if any, of the issuer's cash inflows (including reinvestment earnings) over cash outflows (which often include any debt service and administrative expenses). There are typically three sources of residual cash flows:

a. The differential between interest cash flows on the collateral and interest payments on other investment classes

b. Any overcollateralization provided as a credit enhancement

c. Any income earned on reinvestment of other cash flows before they are distributed to other security holders (because payments on collateral mortgages are received monthly but some investment classes are repaid quarterly or semiannually, these receipts are reinvested in the interim)

5.37 Residuals are often designed to reduce the prepayment risk of other classes and to provide security holders with the potential for high yields. Residuals may earn high yields if prepayments of the underlying collateral are not greater than the rate assumed at the time the issuance was structured and sold. Residuals are particularly sensitive to prepayments, and the residual holder's recorded investment may be lost entirely if actual prepayments are higher than anticipated. As with POs and IOs, residuals may contain credit risk and their fair values are dependent on the effect of discounting.

5.38 While other investment classes may receive triple-A credit ratings, residuals are usually not rated, because they are so susceptible to interest-rate risk. Even if a residual is rated triple-A, such a rating often indicates only that the rating agency expects that the minimum required payments of principal, interest, or both will be received (that is, that credit risk is perceived to be low), not that a security holder will realize the anticipated yield.

5.39 As for other investment classes, the return on and fair value of a residual is dependent on the underlying collateral, the security structure, and its performance under varying interest-rate and prepayment scenarios. Residuals sometimes carry fixed or floating interest rates.

5.40 The fair value of fixed-rate residuals typically increases as interest rates increase and decreases as interest rates decline. The main source of cash flow on a fixed-rate residual comes from the interest differential between the interest payments received on the underlying collateral mortgages and the interest payments made on other investment classes. Because short-term classes usually carry lower interest rates than longer-term classes, residual cash flows from the interest differential tend to be greatest in earlier years after issuance, before the short-term classes have been repaid. Accordingly, the longer the lower-rate classes remain outstanding, the greater the cash flow accruing to the residual class. As interest rates decline, prepayments accelerate, the interest differential narrows, and overall cash flows decline. Conversely, as interest rates climb, prepayments slow, generating a larger cash flow to residual holders.

5.41 The fair value of floating-rate residuals usually performs best in a stable interest-rate environment. As with fixed-rate residuals, the main source of cash flow to floating-rate residuals is the interest differential between interest earned on the collateral and interest paid on other investment classes. However, because one or more of the classes is tied to a floating rate, the interest differential changes when the rates on floating-rate classes are reset. For example, when interest rates rise, the rate on the floating-rate class may be reset at a higher rate. More of the cash flows from the underlying collateral would then be paid to the floating-rate classes, leaving less cash flow for the residual. Higher interest rates also tend to cause prepayments to slow, and thereby increase the period over which the interest-differential income is earned by the residual holders. Conversely, when interest rates decline, rates on floating-rate classes decrease, but prepayments of premium mortgages would tend to accelerate. The loss of interest income as a result of prepayments would typically offset a widening of the interest differential stemming from the lower rate on the floating-rate class, thus reducing the cash flow to the residual. Thus, changes in interest rates produce two opposing effects on the fair value of floating-rate residuals. Whether the value of the residual actually declines or rises when interest rates change depends on the interrelationship between the interest on the floating-rate class and mortgage prepayment speeds.

5.42 *Senior/sub securities.* The senior/sub form of credit enhancement is often used for conventional mortgages. A senior/sub issuance generally divides the offered securities into two risk classes: a senior class and one or more subordinated classes. The subordinated classes, often retained by the sponsor of the ABS, provide credit protection to the senior class. When cash flows on the underlying mortgages are impaired, the cash is first directed to make principal and interest payments on the senior-class securities. Furthermore, some cash receipts may be held in a reserve fund to meet any future shortfalls of principal and interest to the senior class. The subordinated classes may not receive debt-service payments until all of the principal and interest payments have been made on the senior class and, where applicable, until a specified level of funds has been contributed to the reserve fund.

5.43 Subordinated classes generally carry higher interest rates and are often unrated because of the higher credit risk. Accordingly, subordinated classes are not usually purchased to be held to maturity. The fair value of subordinated securities, like the fair value of other mortgage derivatives, depends on the nature of the underlying collateral and how changes in interest rates affect cash flows on the collateral. The fair value would also reflect any reserve fund priorities and the increased credit risk associated with the securities.

Issues of International Organizations and Foreign Governments

5.44 International financial institutions and foreign governments and their political subdivisions increasingly rely on international capital markets for funds. A significant portion of international debt securities is denominated in U.S. dollars. The credit risk and liquidity risk vary for different issues, though many are high quality and widely traded. Institutions have also obtained foreign debt securities of financially troubled countries in troubled debt restructurings; such securities are generally lower quality and not widely traded.

Other Securities

5.45 Other securities held by depository institutions, where permitted by applicable laws and regulations, include the following:

- Common-trust or mutual-investment funds
- Federal Home Loan Bank (FHLB) stock
- Federal Reserve Bank stock
- Equity securities, including venture capital investments
- Corporate bonds and commercial paper

The credit quality and risk of these instruments are unique to the particular issuance. The financial strength of the issuer and other counterparties is a major determinant and may be evidenced by an investment rating.

5.46 ***FHLB Stock.*** Institutions that are members of the FHLB system are required to maintain a minimum investment in FHLB stock. The minimum is calculated as a percentage of aggregate outstanding mortgages. An additional investment is required that is calculated as a percentage of total FHLB advances, letters of credit, and the collateralized portion of interest-rate swaps outstanding. The stock is capital stock issued at $100 par. Both stock and cash dividends may be received on FHLB stock.

Regulatory Matters

5.47 Federal laws and regulations place certain restrictions on the types of financial instruments that an institution may deal in, underwrite, purchase, and sell. Transactions in certain securities, such as those backed by the full faith and credit of the United States, are generally unrestricted. Holdings of other securities—of any one obligor—are generally limited based on capitalization. Restrictions on dealing in or underwriting in the security may also apply. Additional restrictions may apply to state-chartered institutions.

5.48 Savings institutions and their subsidiaries are prohibited from acquiring or holding any corporate debt that, at acquisition, is not rated in one of the four highest rating categories by at least one nationally recognized statistical rating organization.

5.49 The Federal Financial Institutions Examination Council (FFIEC) has issued a policy statement,[2] which was adopted by all of the federal agencies, on securities activities. The policy, the terminology of which predates FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (see paragraph 5.55), addresses selection of securities dealers, policies and strategies for securities portfolios, unsuitable investment practices, and mortgage derivatives.

5.50 The policy emphasizes that securities should be reported in conformity with generally accepted accounting principles consistent with the institution's intent. The policy statement describes investment practices that the agencies consider unsuitable when they occur in an institution's investment securities portfolio (the held-to-maturity portfolio) and accordingly may affect how an institution classifies certain investments in securities. The policy statement recommends that institutions have procedures for ensuring that the described unsuitable investment practices are properly conducted only when permissible by law, appropriately controlled, and properly classified in the financial statements. It also discusses approvals of investment policies and procedures by an institution's board of directors and management. A brief description of practices the agencies consider unsuitable in the held-to-maturity securities portfolio follows:

- Gains trading, which is characterized by the purchase of a security as an investment and the subsequent sale of that same security at a profit within a short period while securities that cannot be sold at a profit are retained. This activity should be conducted only in a trading or held-for-sale (that is, available-for-sale) securities account.
- When-issued securities trading, which involves the buying and selling of securities in the interim between the announcement of an offering and the issuance and payment date of these securities. This activity should be considered trading.
- Pair-offs, which involve security purchase transactions that are closed out or sold at, or prior to, settlement date. This activity should be considered trading.
- Corporate or extended settlements, which involve extending the normal settlement period on U.S. government and federal agency securities purchases beyond the normal or regular settlement period to facilitate speculation. This activity should be considered trading.
- Repositioning repurchase agreements, which is a funding technique often used by dealers to allow buyers to hold a speculative position until it can be sold at a profit. This activity should be considered trading.
- Short sales, which involve the sale of securities that are not owned. This activity should be considered trading.

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[2] The policy statement was published in the February 3, 1992, *Federal Register*, and adopted by the Office of the Comptroller of the Currency (OCC) through revision of Banking Circular 228, by the Federal Deposit Insurance Corporation in Financial Institution Letter (FIL) 7-92, by the Board of Governors of the Federal Reserve System in a Supervisory Release dated January 10, 1992, and by the Office of Thrift Supervision in Thrift Bulletin 52. Subsequent revisions were incorporated through OCC Bulletins 94-25 and 94-48.

- Delegation of discretionary investment authority, which involves delegation of authority to purchase and sell investment securities to a nonaffiliated entity. This requires securities to be reported as held for sale (that is, as available-for-sale securities).
- Covered calls, which involve granting the buyer of the call option the right to purchase a security owned by the option writer. Securities against which covered calls have been written should be classified as held for sale (that is, as available-for-sale securities).

5.51 Adjusted trading, which involves the sale of a security to a broker or dealer at a price above its fair value and the simultaneous purchase of a different security at a price above its fair value, is a prohibited activity, according to the policy.

5.52 The FFIEC policy statement also deals with mortgage derivatives, other ABSs, and zero-coupon bonds. The general principle underlying the policy statement, as it relates to mortgage derivatives, is that those with average life or price volatility in excess of a benchmark fixed-rate thirty-year mortgage-backed pass-through security are considered high risk and are not suitable investments in the held-to-maturity securities portfolio and should be included in the held-for-sale (that is, available-for-sale securities) or trading categories.

5.53 An August 1994 clarification of the FFIEC policy statement (FFIEC FIL 57-94; OCC Bulletin 94-48) addresses the federal banking regulatory agencies' divestiture authority and its effect on an institution's ability to hold a high-risk mortgage security (as defined) to maturity. The announcement states, in part:

> The mere existence of examiners' divestiture authority for high-risk mortgage securities should not preclude an institution from concluding it has the intent and ability to hold to maturity those securities that were nonhigh-risk when acquired.

See paragraph 5.73.

5.54 Net unrealized holding losses on equity securities classified as available for sale in conformity with FASB Statement No. 115 are included in calculation of Tier I capital. However, all other unrealized holding gains and losses on available-for-sale securities are not included in calculation of Tier I capital.

Accounting and Financial Reporting

5.55 FASB Statement No. 115 addresses accounting and reporting for investments in equity securities that have readily determinable fair values and for all investments in debt securities.[3,4] Those investments are to be classified in three categories and accounted for as follows:

a. Held-to-maturity securities (only those debt securities for which the institution has the positive intent and ability to hold to maturity) are reported at amortized cost.

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[3] See paragraph 137 of FASB Statement No. 115 for related definitions of security, debt security, and equity security.

[4] The FASB also published a FASB Special Report, *A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities*.

b. Trading securities (debt and equity securities that are bought and held principally for the purpose of selling them in the near term) are reported at fair value, with unrealized gains and losses included in earnings.[5]

c. Available-for-sale securities (debt and equity securities are not classified as either held to maturity or trading) are reported at fair value, with unrealized gains and losses excluded from earnings and reported as a net amount in a separate component of shareholders' equity until realized.[6]

5.56 Paragraph 8 of FASB Statement No. 115 addresses changes in circumstances that may cause the enterprise to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future. The "Regulatory Matters" section, paragraphs 5.47 through 5.54, discusses the effect regulations may have on the classification of securities in the three categories.

5.57 For individual securities classified as either available for sale or held to maturity, paragraph 16 of FASB Statement No. 115 requires institutions to determine whether a decline in fair value below the amortized cost basis is other than temporary. For example, if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred. If such a decline is judged to be other than temporary, the cost basis of the individual security should be written down to fair value as the new cost basis, with the amount of the write-down included in earnings (that is, accounted for as a realized loss).[7] The new cost basis shall not be changed for subsequent recoveries in fair value.

5.58 Paragraph 15 of the Statement specifies accounting for transfers between categories.

5.59 FASB Technical Bulletin No. 94-1, *Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring*, clarifies that any loan that was restructured in a troubled debt restructuring involving a modification of terms, including those restructured before the effective date of FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, would be subject to the provisions of FASB Statement No. 115 if the debt instrument meets the definition of a security (as provided in FASB Statement No. 115).

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[5] MBSs that are held for sale in conjunction with mortgage banking activities (as described in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*) are classified as trading securities.

[6] Paragraph 36 of FASB Statement No. 109, *Accounting for Income Taxes*, provides guidance on reporting the tax effects of unrealized holding gains and losses reported in a separate component of shareholders' equity. Specifically, paragraph 36(b) of FASB Statement No. 109 says that the tax effects of gains and losses that occur during the year and are included in comprehensive income but excluded from net income (for example, changes in the unrealized holding gains and losses of securities classified as available-for-sale under FASB Statement No. 115) are charged or credited directly to the related component of shareholders' equity.

[7] A decline in the value of a security that is other than temporary is also discussed in Auditing Interpretation No. 1 of Statement on Auditing Standards (SAS) No. 1, section 332, *Long-Term Investments,* entitled "Evidential Matter for the Carrying Amount of Marketable Securities" (AICPA, *Professional Standards*, vol. 1, AU sec. 9332) and in Securities and Exchange Commission (SEC) Staff Accounting Bulletin No. 59, *Accounting for Noncurrent Marketable Equity Securities*. The Auditing Standards Board (ASB) has a project under way that could result in amendments of SAS No. 1, section 332, including the related interpretations. Readers should be alert to any final amendment.

Premiums and Discounts

5.60 An institution will often pay less (or more) for a security than the security's face value.[8] Accretion of the resulting discount (or amortization of the premium) increases (or decreases) the effective rate of interest on the security, thereby reflecting the security's market yield. FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, specifies that discounts or premiums associated with the purchase of debt securities should be accreted or amortized using the interest method—that is, to arrive at periodic interest income at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase discount or premium).

5.61 The period of amortization or accretion for debt securities should generally extend from the purchase date to the maturity date, not an earlier call date. Paragraph 19 of FASB Statement No. 91 permits expected maturity dates to be used for holdings of large numbers of similar loans for which prepayments are probable and the timing and the amount of the prepayments can be reasonably estimated. Certain ABSs may meet those conditions, and institutions should consider estimates of prepayments in determining the amortization period for calculation of the constant yield. If the institution anticipates prepayments in applying the interest method and a difference arises between the anticipated prepayments and the actual prepayments received, the effective yield should be recalculated to reflect actual payments to date and anticipated future payments. The net investment should be adjusted to the amount that would have existed had the new effective yield been applied since purchase. The investment should be adjusted to the new balance with a corresponding charge or credit to interest income.

5.62 ***POs.*** In general, purchase discounts on POs are recognized by the interest method over the contractual life of the related instrument in conformity with FASB Statement No. 91. However, POs ordinarily meet the criteria in paragraph 19 of FASB Statement No. 91 that permit accretion of discounts using expected maturity dates.

Impairment of Value of ABSs

5.63 When adverse interest-rate and prepayment-rate assumptions are projected, the institution may not recover its investment and there are generally no actions that the institution or the issuer can take to remedy the anticipated shortfall. The institution should determine whether an other-than-temporary impairment has occurred (see paragraphs 5.57 and 5.66).

Special Areas

5.64 As listed below, several specialized accounting issues involving investments have been addressed by the FASB's Emerging Issues Task Force (EITF).

5.65 ***Loan Conversions.*** EITF Issue No. 94-8, *Accounting for Conversion of a Loan into a Debt Security in a Debt Restructuring*, addresses accounting for such conversions.

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[8] FASB Statement No. 115 does not affect the methods used for recognizing and measuring the amount of dividend and interest income (see paragraph 14 of FASB Statement No. 115).

5.66 ***Impairment of Certain Mortgage Securities.*** EITF Issue No. 93-18, *Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*, addresses issues associated with impairment of such instruments.

5.67 ***Mortgage-Derivative Securities.*** EITF Issue No. 89-4, *Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*, as amended by EITF Issue No. 93-18, applies to CMOs, IOs, and REMICs and addresses—

- Which factors should be considered in determining whether to account for certain securities as equity or non-equity.
- What attributes of certain non-equity high-risk securities distinguish them as a group of instruments that should be accounted for similarly.
- Accounting for certain non-equity high-risk securities in subsequent periods.

5.68 ***Sales of Marketable Securities With Put Arrangements.*** Accounting for sales of marketable securities with put arrangements is addressed in EITF Issues No. 84-5, *Sale of Marketable Securities with a Put Option*, No. 85-25, *Sale of Preferred Stocks with a Put Option*, No. 85-30, *Sale of Marketable Securities at a Gain with a Put Option*, and No. 85-40, *Comprehensive Review of Sales of Marketable Securities with Put Arrangements*.

5.69 *Mutual funds.* Accounting for investments in certain mutual funds is addressed in EITF Issue No. 86-40, *Investments in Open-End Mutual Funds That Invest in U.S. Government Securities*.

5.70 ***Investments Required to be Divested.*** EITF Issue No. 89-18, *Divestitures of Certain Investment Securities to an Unregulated Commonly Controlled Entity under FIRREA* (as amended by FASB Statement No. 115), addresses accounting for such securities.

5.71 EITF Issue No. 89-18 did not address accounting for the subsequent sale of the securities to an affiliate or accounting in consolidated financial statements; however, the SEC staff observer at the EITF meeting noted that gain recognition would not be appropriate when the securities are sold to an affiliate. Further, paragraph 6 of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, states that consolidated financial statements should not include gain or loss on transactions among the companies in the group.[9]

5.72 EITF Issue No. 89-18, as amended, requires that investments in securities required to be divested should be reported as available for sale at fair value (see paragraph 5.55). The fair value for these securities can be difficult to determine, depending on the availability of third-party quotations that are limited at times because of a lack of market activity in these securities. Junk bonds, for example, are often issued by companies without long track records of sales and earnings, by established companies the profitability of which has declined, or by entities with questionable credit. Additionally, junk bonds have been used to finance leveraged corporate acquisitions in which the assets of the company being acquired serve as collateral for the securities. Institutions have been attracted to the potentially higher yields on junk bonds relative to higher-grade bonds.

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[9] In October 1995, the FASB issued a proposed Statement, *Consolidated Financial Statements: Policy and Procedures*. Comments on the proposed Statement were due in January 1996. Readers should be alert to any final pronouncement.

5.73 ***Other Issues.*** Appendix D-39 to the *EITF Abstracts* contains FASB staff responses to certain technical inquiries about implementation of FASB Statement No. 115. Included is a discussion of whether a mortgage-derivative product (held by a regulated institution) that is not a high-risk mortgage security (as defined in the FFIEC's December 1991 "Supervisory Policy Statement on Securities Activities" discussed in paragraph 5.49 herein) at purchase, but that could later become a high-risk mortgage security before maturity because of a change in market interest rates and the related change in the security's prepayment risk, may be classified at acquisition as a held-to-maturity security under FASB Statement No. 115. In Appendix D-39, the FASB staff announced that it believes this FFIEC conclusion is consistent with the provisions of FASB Statement No. 115. The EITF agreed that "transfer of an available-for-sale security into the held-to-maturity category in response to the [FFIEC's August 8, 1994] final memorandum should be accounted for at the security's fair value at the time of transfer." The EITF also agreed that "such a transfer could not occur prior to issuance of the [FFIEC's August 8, 1994] final memorandum" and that "the transfer should be accounted for in accordance with paragraph 15(d)" of FASB Statement No. 115.

5.74 Appendix D-44 to the *EITF Abstracts* includes a discussion of when an institution should recognize an other-than-temporary impairment if it has decided to sell a specifically identified available-for-sale debt security at a loss shortly after the reporting date.

Sales of Securities

5.75 Purchases and sales of securities are recorded in the balance sheet on the trade date. Gains and losses from security sales or disposals should be recognized as of the trade date in the statement of operations for the period in which securities are sold or otherwise disposed of.[10] FASB Statement No. 115 states that sales or transfers from securities classified as held to maturity should be rare, except for sales or transfers due to changes in circumstances identified in the Statement.

5.76 ***Wash Sales.***[11,12] In practice, accounting questions arise about whether a sale of securities should be recognized when an institution sells or swaps securities with the intent to reacquire the same or substantially the same securities at some future date (*wash sales*). Though the period of time between sale and reacquisition varies, it is often very short, especially when securities with a ready market are involved. In some cases, the securities remain in the possession of the seller. If securities are sold and the same or substantially the same securities[13] are repurchased soon thereafter, the insti-

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[10] Paragraph 8.14 of the Guide discusses accounting for sales of loans that have not been previously securitized.

[11] Paragraph 9 of FASB Statement No. 115 says that an institution should not classify a debt security as held-to-maturity if the institution has the intent to hold the security for only an indefinite period. Further, paragraph 71 of FASB Statement No. 115 says that securities that may need to be sold to implement tax-planning strategies should be classified as available-for-sale, not held-to-maturity.

[12] In October 1995, the FASB issued a proposed Statement, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The proposed Statement would significantly affect accounting for (including disclosures about) securitizations, sales of partial interests, servicing assets and liabilities, securities lending transactions, repurchase agreements, "wash sales," loan syndications and participations, risk participations in banker's acceptances, factoring arrangements, and transfers of receivables with recourse.

Comments on the proposed Statement were due in January 1996. Readers should be alert to any final pronouncement.

[13] Paragraph 12.29 contains six criteria that must be met for debt securities to be considered substantially the same.

tution may be in essentially the same economic position after the sale and repurchase as it was before the transactions, notwithstanding the fact that it has possibly incurred brokerage fees and taxes. Wash sales should be considered a completed sale only if substantially all risks, benefits, and potentials of ownership have been transferred.

5.77 When an institution sells a security and concurrently reinvests the proceeds from the sale in the same or substantially the same security, a sale should not be reported. However, when the proceeds are not reinvested immediately, but soon thereafter, the kinds of securities involved and the circumstances of the particular transactions should be considered in determining whether a sale should be reported. For example, a few days may be a reasonable period of time for a quoted security that has a history of significant market price fluctuations over a short period of time. An institution's liquidity needs may require replacement of a long-term bond with a short-term, money market instrument. If the institution's liquidity requirements change a week later, the bond may be reacquired, wholly independent of the previous decision to sell.

5.78 ***Short Sales.*** Short sales are trading activities in which an institution sells securities it does not own, with the intention of buying or borrowing securities at an agreed-upon future date to cover the sale. Securities are sold short for protection against losses, for short-term borrowing of funds, for arbitrage, or in anticipation of a decline in market prices. The obligations incurred in short sales should be reported as liabilities and adjusted to fair value through the income statement at each reporting date. Such liabilities are generally called "securities sold, not yet purchased." Interest on the short positions should be accrued periodically and reported as interest expense.

5.79 When an institution sells securities short and holds identical securities in its held-to-maturity classification, it should be determined whether the transaction is, in substance, a short sale or a sale of the security held to maturity. The transaction may be considered a short sale if investment and trading are separate functions within the institution, management can support and has documented its intention to enter into a short sale, and securities classified as held to maturity are not used to make delivery. If these conditions are not present, the short sale should be considered completed at the time of the initial sale and the resulting gain or loss should be recognized immediately.

Borrowing and Lending Securities[14]

5.80 ***Securities Borrowed.*** Sometimes an institution will borrow securities from a counterparty or from its trust assets when the institution is obligated to deliver securities it does not own (for example, in a short sale or under a repurchase agreement). (For example, a counterparty may have failed to deliver securities.) The institution, therefore, uses borrowed securities to fulfill its obligation until it actually receives the securities it has purchased.

5.81 An institution may advance cash, pledge other securities, or issue letters of credit as collateral for borrowed securities. The amount of cash or other collateral required may increase or decrease depending on changes in the value of the securities.

5.82 Cash advances are typically made in an amount greater than the market value of the securities borrowed. The institution borrowing securities records cash advanced as collateral as a receivable from the lender of securities.

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[14] See footnote 12 in this chapter.

Any rebate (that is, interest received by the securities borrower on the cash it advances) is reported as interest income. When the institution returns the borrowed securities to the counterparty, the counterparty returns the cash, typically in an amount equal to the market value of the securities when borrowed and adjusted for subsequent mark-to-market calls.

5.83 When an institution pledges other securities as collateral for borrowed securities, the institution discloses the transaction in the financial statements.

5.84 ***Securities Loaned.*** When securities are loaned to a counterparty, the institution records a liability for the amount of any cash the counterparty advances as collateral. The liability represents the institution's obligation to return the cash collateral to the borrower of securities when that borrower returns the loaned securities.[15] The amount of cash or other collateral required may increase or decrease depending on changes in the value of the securities. Any rebate (that is, interest paid to the counterparty on the cash it advances) is reported as interest expense.

5.85 ***Offsetting.*** Balances arising from securities borrowed and loaned should be reported gross on the balance sheet unless the provisions of FASB Interpretation No. 39, *Offsetting Amounts Related to Certain Contracts*, are met. FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*, does not apply to securities borrowing and lending transactions.

Troubled Debt Restructurings

5.86 FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, applies to troubled debt restructurings involving debt securities, including instances in which there is a substitution of debtors. FASB Statement No. 114 sets forth accounting for troubled debt restructurings involving a modification of terms of a receivable. This topic is discussed in more detail in chapter 6.

Amortization of Discounts on Certain Debt Securities

5.87 The Accounting Standards Executive Committee (AcSEC) issued AICPA Practice Bulletin 6, *Amortization of Discounts of Certain Acquired Loans*, in 1989 to provide guidance on the accounting and reporting by purchasers of certain acquired loans or other debt securities (as defined).[16] For acquired loans or other debt securities within its scope, Practice Bulletin 6 includes guidance on (*a*) amortization of discounts that reflect impairment due to credit risk, (*b*) initial and subsequent recognition of principal and interest, and (*c*) assessing collectibility. For loans within the scope of FASB Statement No. 114, Practice Bulletin 6's provisions on these issues are inconsistent with certain provisions of FASB Statement No. 114, as amended by FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*, (and related amendments of FASB Statement No. 5, *Accounting for Contingencies*, and No. 15) and FASB Statement No. 115. AcSEC is considering actions that it should take on Practice Bulletin 6; how-

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[15] The credit balance reflecting the liability to the counterparty is associated with the cash collateral the institution receives, not the institution's ownership of the securities that were loaned in the transaction. See footnote 12 in this chapter.

[16] Related financial reporting by liquidating banks is beyond the scope of Practice Bulletin 6 and was addressed in EITF Issue No. 88-25, *Ongoing Accounting and Reporting for a Newly Created Liquidating Bank*.

ever, FASB Statements No. 114, No. 115, and No. 118 take precedence for loans and debt securities within their scope. Readers should be alert to any final action on Practice Bulletin 6.

FHLB or Federal Reserve Bank Stock

5.88 Although FHLB (or Federal Reserve Bank) stock is an equity interest in a FHLB (or Federal Reserve Bank), it does not have a readily determinable fair value for purposes of FASB Statement No. 115, because its ownership is restricted and it lacks a market. FHLB (or Federal Reserve Bank) stock can be sold back only at its par value of $100 per share and only to the FHLBs (or Federal Reserve Banks) or to another member institution. Therefore, FHLB (or Federal Reserve Bank) stock is more properly classified as a restricted investment security, carried at cost, and evaluated for impairment.

5.89 In addition, the equity ownership rights represented by FHLB stock are more limited than would be the case for a public company, because of the oversight role exercised by the Federal Housing Finance Board in the process of budgeting and approving dividends.

5.90 Both cash and stock dividends are received on FHLB stock and are reported as income. The stock dividends are redeemable at par value.

5.91 In evaluating the effects of legislation on the FHLBs, the independent accountant may presume that at least a temporary decline in value could have occurred if such legislation requires an FHLB to make payments to the Resolution Funding Corporation (REFCORP) or other entities in addition to the required payments to the Financing Corporation (FICO) and if these payments cause the FHLB's total equity to fall below its aggregate capital stock amount. FHLB stock is generally viewed as a long-term investment. Accordingly, its value should be determined based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The determination of whether the decline is other than temporary in nature is influenced by criteria such as—

- The significance of the decline in net assets of the FHLBs as compared to the capital stock amount for the FHLBs and the length of time this situation has persisted.
- Commitments by the FHLBs to make future payments to REFCORP and other entities and the level of such payments in relation to the operating performance of the FHLBs.
- The impact of legislative and regulatory changes on the savings institutions industry and, accordingly, on the customer base of the FHLBs.
- The liquidity position of the FHLBs.

5.92 The evaluation of whether a decline is temporary or whether it affects the ultimate recoverability of the FHLB stock is ultimately made by the member institution and concurred with by its independent accountants based on the facts at the time. This consideration is influenced by (*a*) the materiality of the carrying amount to the member institution and (*b*) whether an assessment of the institution's operational needs for the foreseeable future would require and allow management to dispose of the stock.

Financial Statement Presentation and Disclosure

5.93 The notes to the financial statements should include an explanation of the institution's accounting policy for securities, including the basis for classification.

5.94 Paragraphs 19 and 20 of FASB Statement No. 115 require that the following information about held-to-maturity and available-for-sale securities be disclosed separately for each of those categories:

a. For each statement of financial position presented, the fair value, gross unrealized holding gains, gross unrealized holding losses, and amortized cost[17] basis by major security type. Major security types include, but are not limited to, the following:
- Equity securities
- Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies
- Debt securities issued by states within the United States and political subdivisions of the states
- Debt securities issued by foreign governments (including those classified as loans)
- Corporate debt securities
- Mortgage-backed securities
- Other debt securities

b. Information about the contractual maturities of securities as of the date of the most recent statement of financial position. Maturity information may be combined in appropriate groupings.[18] These disclosures should include the fair value and amortized cost of debt securities based on at least the four following maturity groupings:
- Within one year
- After one year through five years
- After five years through ten years
- After ten years

5.95 For each period for which the results of operations are presented, paragraph 21 of FASB Statement No. 115 requires that the institution disclose—

a. The proceeds from sales of available-for-sale securities and the gross realized gains and gross realized losses on those sales.

b. The basis on which cost was determined in computing realized gain or loss (that is, specific identification, average cost, or other method used).

c. The gross gains and gross losses included in earnings from transfers of securities from the available-for-sale category into the trading category.

d. The change in net unrealized holding gain or loss on available-for-sale securities that has been included in the separate component of shareholders' equity during the period.[19]

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[17] Amortized cost is the face amount of the security increased or decreased by unamortized premium, discount, finance charges, or acquisition fees and costs and may also reflect a previous direct write-down of the security.

[18] Securities not due at a single maturity date, such as MBSs, may be disclosed separately rather than allocated over several maturity groupings; if allocated, the basis for allocation should be disclosed.

[19] FASB Statement No. 109 requires that income tax expense or benefit for the year be allocated among continuing operations, discontinued operations, extraordinary items, and items charged or credited directly to shareholders' equity (such as changes in the unrealized holding gains and losses of securities classified as available for sale [see chapter 14]).

e. The change in net unrealized holding gain or loss on trading securities held at period-end that has been included in earnings during the period.

For any sales of or transfers from securities classified as held to maturity, paragraph 22 of FASB Statement No. 115 requires the amortized cost amount of the sold or transferred security, the related realized or unrealized gain or loss, and the circumstances leading to the decision to sell or transfer the security should be disclosed in the notes to the financial statements for each period for which the results of operations are presented. Such sales or transfers should be rare, except for sales and transfers due to the changes in circumstances identified in FASB Statement No. 115, subparagraphs 8a—f, or sales that are considered maturities in accordance with the criteria in paragraph 11.

5.96 FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, requires certain disclosures of financial instruments with off-balance-sheet credit or market risk and disclosure of significant concentrations of credit risk for all financial instruments. The concentrations-of-credit-risk disclosures apply to debt securities as well as loans and are discussed further in paragraphs 6.75 and following. (Off-balance-sheet risk disclosures are discussed in chapters 6 and 15.)

5.97 FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, requires all entities to disclose the fair value of financial instruments for which it is practicable to estimate fair value.

5.98 The carrying amount of investment assets pledged to secure public funds, securities sold under repurchase agreements, and for other borrowings should also be disclosed in the notes to the financial statements.[20]

Auditing

Objectives

5.99 The primary objectives of audit procedures in this area are to obtain reasonable assurance that—

a. Securities, accrued interest, discounts and premiums, and other investment assets of the institution—
- Exist at the balance-sheet date (definitive securities are on hand or held by others in custody or safekeeping for the account of the institution).
- Are the rights of the institution at the balance-sheet date.
- Have been properly classified, described, and disclosed in the financial statements at appropriate amounts (including consideration of any other-than-temporary declines in value and disclosure of any securities pledged as collateral for other transactions).

b. Sales of securities and other transactions that—
- Have been recorded have occurred during the given period.
- Should be presented in the financial statements are so included.

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[20] See footnote 12 in this chapter.

c. Realized and unrealized gains and losses, and interest (including premium amortization and discount accretion), dividend, and other revenue components—
- Have been included in the financial statements at appropriate amounts.
- Are properly classified, described, and disclosed.

Planning

5.100 In planning the audit of investments, the independent accountant should consider the factors influencing inherent risk, which are described in chapter 3, as they relate to financial statement assertions about investments. The primary inherent risks—interest-rate risk, credit risk, and liquidity risk—are interrelated. For example, increases in market interest rates may affect other risk factors by decreasing marketability (that is, liquidity) or by increasing the credit risk of the issuer's obligations. The independent accountant should have an understanding of the relationship between the interest-rate environment and the market values of securities. The institution's asset/liability and other risk management policies may provide useful information about the possible effects of interest rate and liquidity risks on the institution's securities.

5.101 Classification of investments in securities among the held-to-maturity, available-for-sale, and trading categories is important because it directly affects the accounting treatment. The classification of securities, which must occur at acquisition, should be consistent with the institution's investment, asset/liability, and other risk management policies. In planning the audit, the independent accountant should consider reading the current year's interim financial statements, investment policy, and other financial information related to securities. The level of inherent risk for securities varies widely from institution to institution depending on, among other things, the nature and complexity of the securities and the extent and effectiveness of the institution's accounting and operational policies and procedures, as well as management's understanding and awareness of the risks. The following factors related to securities may, considered in the aggregate, indicate higher inherent risk:

a. Significant concentrations of credit risk with one counterparty or within one geographic area

b. Significant use of derivative securities (including ABSs or off-balance-sheet instruments), particularly without relevant in-house expertise

c. High volumes of borrowing or lending of securities

d. Relatively high volatility in interest rates

e. Changes in the terms of government guarantees

f. Actual prepayment experience that differs significantly from that anticipated

g. Declines in the values of collateral underlying securities

h. Changes in guarantors' claims processing

i. Significant conversion options related to the collateral (for example, variable to fixed rates)

j. Sales and transfers from the held-to-maturity securities portfolio *k.* High volume of transactions in the available-for-sale or trading securities portfolios

l. Wash sale transactions

m. Uncertainty regarding the financial stability of an ABS servicer or of guarantors

Internal Control Structure Over Financial Reporting and Possible Tests of Controls[21]

5.102 An effective internal control structure, as it relates to financial reporting of investments in securities, should provide reasonable assurance that—

a. Securities transactions are executed in accordance with management's established policies.

b. Physical securities are on hand or held in custody or safekeeping by others in accordance with management's authorization.

c. Errors and irregularities in the processing of accounting information for investments in securities are prevented or detected.

d. Securities are monitored on an ongoing basis to determine whether recorded financial statement amounts require adjustment.

5.103 The independent accountant's assessment of control risk for investments should include consideration of the extent to which the institution has internal control structure policies and procedures that contribute to a strong control environment.

5.104 Management policies that would contribute to internal controls over financial reporting in this area include policies, adopted by the board of directors or its investment committee, that establish authority and responsibility for investments in securities. Such policies may address investment objectives and guidelines, including specific position limits for each major type of investment, provisions for assessing risks of alternative investments, and policies on evaluating and selecting securities dealers and safekeeping agents. They also may set forth procedures for ensuring that management's investment directives are carried out and for gathering, analyzing, and communicating timely information about investment transactions. The policy statement discussed beginning in paragraph 5.49 establishes regulatory requirements for such policies.

5.105 Risk assessment is important to strong internal controls over financial reporting of securities. The institution should have procedures to analyze alternative securities (including complex derivatives) according to the institution's intent, with consideration of the level of management expertise, the sophistication of the institution's control procedures and monitoring systems,

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[21] In December 1995, the ASB issued SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards,* Vol. 1, AU sec. 319). SAS No. 78 revises the definition and description of internal control contained in the SASs to recognize the definition and description contained in *Internal Control—Integrated Framework* published by the Committee of Sponsoring Organizations of the Treadway Commission. SAS No. 78 is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted.

In conjunction with SAS No. 78, the ASB issued Statement on Standards for Attestation Engagements (SSAE) No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2* (AICPA, *Professional Standards,* vol. 1, AT sec. 400). SSAE No. 6 conforms the description of elements of an entity's internal control to the components of internal control contained in SAS No. 78 and the *Internal Control—Integrated Framework*. SSAE No. 6 is effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, with earlier application permitted.

its asset/liability structure, and its capacity to maintain liquidity and absorb losses out of capital. For example, analyses prepared for derivative securities prior to purchase would generally include sensitivity analyses that show the effect on the carrying amount and net interest income of various interest-rate and prepayment scenarios. Such analyses may also evaluate the effect of investment securities on the institution's overall exposure to interest-rate risk. An analysis might also be performed to evaluate the reasonableness of interest-rate and prepayment assumptions provided by the selling broker, and management may obtain price quotes from more than one broker prior to executing a trade. Internal control procedures in this area may also include a review by management of contractual documents to ascertain the rights and obligations of all parties to the transaction, as well as the recourse available to each party.

5.106 Other control procedures that contribute to a strong internal control structure over financial reporting of securities include the following:

- Procedures exist to identify and monitor credit risk, prepayment risk, and impairment.
- The board of directors—generally through an investment committee—oversees management's securities activities.
- Changes in investment policy are reviewed and approved by the board of directors (or its investment committee) and recorded in the minutes.
- Accounting entries supporting securities transactions are periodically reviewed by supervisory personnel to ensure that classification of securities was made and documented at acquisition (and date of transfer, if applicable) and is in accordance with the institution's investment policy and management's intent.
- Recorded securities are periodically reviewed and compared to safekeeping ledgers and custodial confirmations, on a timely basis, including immediate and thorough investigation and resolution of differences and appropriate supervisory review and approval of completed reconciliations.
- Current fair values of securities are obtained and reviewed on a timely basis.
- Securities loaned to other entities or pledged as collateral are designated as such.
- Procedures exist for the review, selection, and monitoring of securities dealers.
- Lists of authorized signers are reviewed and updated periodically, and transaction documentation is compared to the authorized lists.
- There is appropriate segregation of duties among those who (*a*) execute securities transactions, (*b*) approve securities transactions, (*c*) have access to securities, and (*d*) post or reconcile related accounting records.
- Buy and sell orders are routinely compared to brokers' advices.
- Adjustments to securities accounts (for example, to recognize impairments) are reviewed and approved by the officials designated in management's policy.
- Periodic tests of interest and dividend income are performed by reference to supporting documentation, which may include using analytical procedures commonly referred to as yield analysis. (With this approach, actual yields during the period are compared to expected yields based on previous results and current market trends. Any significant differences should be investigated and explained.)

- Securities are monitored on an ongoing basis and factors affecting income recognition and the carrying amount of the securities are analyzed periodically to determine whether adjustments are necessary.

5.107 Many of the control procedures for securities are often performed directly by senior management. While management's close attention to securities transactions can be an effective factor in the control structure, the independent accountant should be alert to potential abuses and override of policies and procedures when such circumstances exist.

5.108 The independent accountant also should consider the guidance of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), if the institution uses a service organization to execute, record, or process securities transactions.

5.109 The independent accountant may decide to perform procedures to obtain evidential matter about the effectiveness of both the design and operation of internal control structure policies and procedures to support a lower level of assessed control risk. Examples of tests of controls that might be considered include—

- Reading minutes of meetings of the board of directors (and any investment committee) for evidence of the board's periodic review of securities activities made so that the board may determine adherence to the institution's investment policy.
- Comparing securities transactions, including transfers, to the institution's investment policy to determine whether the institution is following its investment policy. For example, the independent accountant may include—
  - — Testing that any preacquisition sensitivity analysis required by the investment policy is being performed or that transactions have been executed in accordance with authorizations specified in the investment policy.
  - — Testing transactions to determine whether the institution obtained required approvals for the transactions and used only authorized brokers.
  - — Inquiring of management about whether securities portfolios and related transactions (including impairments) are being monitored on a timely basis and reading supporting documentation.
  - — Testing recorded purchases of securities, including that classification of the securities and prices and entries used to record related amounts (for example, use of trade versus settlement date, and treatment of commissions, premiums and discounts).
- Recalculating a sample of premium and discount amortization and gains and losses on sales.
- Reviewing controls over accumulating information necessary for financial statement disclosures.
- Testing the reconciliation process. The independent accountant might test whether reconciling differences are investigated and resolved and whether the reconciliations are reviewed and approved by supervisory personnel.

Substantive Tests

5.110 ***Physical Inspection and Confirmation.*** The independent accountant may consider physically inspecting and counting securities owned by the institution and held at the institution's premises noting that securities recorded in the accounting records are on hand. The independent accountant may consider confirming any securities pledged or held for the institution by third-party custodians including the Federal Reserve Bank and confirming with the FHLB any FHLB stock pledged as collateral for any FHLB advances. Book-entry securities may be confirmed with the trustee. SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), provides guidance on the use of confirmations.

5.111 If the institution is a member of the FHLB or Federal Reserve System, the independent accountant should consider (*a*) confirming stock ownership with the related FHLB or Federal Reserve Bank and (*b*) reconciling the dollar amount of the shares with the institution's general ledger. For institutions holding FHLB stock, the independent accountant should consider the status of the FHLB's redemption of its stock at par value before concluding that income recognition is appropriate for any FHLB stock dividends.

5.112 ***Classification.*** The independent accountant should evaluate the classification of securities. FASB Statement No. 115 describes (*a*) circumstances under which a debt security should not be classified as held to maturity (subparagraphs 9a–e) and (*b*) circumstances in which the sale or transfer of a held-to-maturity security is not considered to be inconsistent with its original classification (subparagraphs 8a–f). The independent accountant should normally consider historical investment activity of the institution.

5.113 ***Valuation.*** As discussed in the "Accounting and Financial Reporting" section of this chapter, securities are carried at amortized cost or fair value depending on their classification. Further, fair values should be disclosed for all securities that are not carried at fair values. Accordingly, the independent accountant should test both the amortized cost and fair value of securities regardless of how they are classified. Amortized cost may be tested by reference to the investment documents and recomputation of discount accretion or premium amortization and of accruals and collections of interest. The independent accountant should also test write-downs related to other-than-temporary declines in the fair values of securities.

5.114 For securities for which there is a market price, the independent accountant may test fair value by reference to third-party market quotations. Tests of fair values of securities for which there is no active market should also be performed. There are a variety of methodologies that institutions use to estimate fair values of securities, including discounting expected cash flows using current interest rates and options pricing models. Securities brokers and dealers are often used as a source of some of the information used in the estimates, particularly information regarding recent payments and repayment experience for ABSs. For certain securities for which fair value estimates are particularly subjective and sensitive to changes in assumptions, the independent accountant may wish to obtain corroboration from more than one source.

5.115 SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance on auditing estimates (such as estimates of fair values). SAS No. 57 discusses how an independent accountant obtains an understanding of how management developed estimates, concentrating on the key factors and assumptions used. It also discusses how an independent accountant may evaluate the reasonableness of management's estimate through use of one or a combination of the following approaches: (*a*) reviewing and testing the process used by management to develop an estimate, (*b*) developing an independent expectation of the estimate, (*c*) reviewing subsequent amounts of transactions occurring prior to the completion of fieldwork.

5.116 The independent accountant should be familiar with the Auditing Interpretation No. 1 of SAS No. 1, Section 332, which provides guidance on the evidence the independent accountant should obtain pertaining to classification and carrying value of marketable securities.[22]

5.117 ***Securities Gains and Losses.*** The independent accountant should consider obtaining schedules of securities activity, including beginning balances, additions, sales, principal repayments, prepayments, and ending balances, and then determine the nature, timing, and extent of procedures for testing additions and sales. Such tests might include comparison of recorded purchases and sales of securities (and any resultant gains, losses, premiums, or discounts) to purchase or sale advice received from brokers.

5.118 ***Accrued Interest Receivable and Interest Income.*** Computer-assisted audit techniques are often an effective and efficient way to test accrued interest receivable, unamortized discounts and premiums, and interest income. While analytical review procedures may provide evidence about the reasonableness of these amounts, it is normally difficult to develop expectations to be used in analyzing yields on investments. Significant differences between expected and actual yields should be investigated to ensure they were adequately resolved. Interest income tests can be supplemented with monthly analytical tests by type of investment. Accrued interest receivable may be vouched to the subsequent receipt of the accrued interest.

5.119 ***Analytical Procedures.*** In using analytical procedures as a substantive test, the independent accountant should consider the implications of changes in important relationships and the extent of the difference between actual and expected results that can be accepted without further investigation. It is normally difficult to develop expectations to be used in analyzing yields on securities as a substantive test of related income amounts. Accordingly, analytical procedures in this area should generally be considered only as a supplement to other substantive procedures, except where an expected yield can be known with some precision.

5.120 The reasons for variations from expectations should be identified, analyzed, and investigated. The independent accountant should be alert to unusually high or low yields. High yields are often an indication of high interest rate, liquidity, or credit risk. Low yields are often an indication of declines in the value of securities. Additional guidance on the use of analytical procedures is provided by SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329). Analytical procedures that the independent accountant may consider include the following:

- Comparison of current-year interest and dividend income, related accruals, and prepayment experience to expectations based on average asset balances during the year and prior year's income
- Review of detailed securities listings and subsidiary ledgers to ascertain changes in mix between kinds of securities to facilitate adequate disaggregation for developing estimates about accruals and yields
- Computation of average yield throughout the period for each kind of security on a monthly or quarterly basis and comparison of results against contractual and effective yields

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[22] See footnote 7 in this chapter.

- Comparison of current-year activity in the trading, available-for-sale, and held-to-maturity categories to the institution's investment policy and stated intent at acquisition
- Comparison of yields during the period with expected yields based on previous results and current market trends

5.121 ***Other Procedures.*** Other audit procedures related to securities that the independent accountant may generally consider performing include the following:

- Examine transactions for evidence of short sales or wash sales and if they exist, evaluate whether they have been properly accounted for in the financial statements.
- For certain complex derivative securities, review information considered necessary to gain an understanding of the nature and risks of individual securities (such as offering circulars, contracts, descriptions, and reports from the broker).

Chapter 6

Loans

Introduction

6.01 Loans usually are the most significant assets of banks and savings institutions and generate the largest portion of revenues. Like investments, an institution's management of its loans is an integral part of its asset/liability management strategy (which is discussed in chapter 1). Institutions originate loans, purchase loans or participating interests in loans, sell loans or portions of loans, and securitize loans (the latter two activities are discussed in chapter 8). Because lending activities are influenced by many factors, including the type of institution, management's objectives and philosophies regarding diversification and risk (credit strategy), the availability of funds, credit demand, interest-rate margins, and regulations, the compositions of loan portfolios differ considerably among institutions. Further, the composition of a particular institution's loan portfolio may vary substantially over time.

The Lending Process

6.02 To plan and design audit procedures properly, the independent accountant needs to understand the institution's loan portfolio, lending processes, loan accounting policies, market specialty, and trade area, as well as other factors such as economic conditions. This section discusses certain characteristics of, and considerations involved in, the lending process. The specific features will vary from institution to institution.

Credit Strategy

6.03 The institution's credit strategy includes its defined goals and objectives for loans, as well as the loan policies written to help achieve those goals and objectives. A guiding principle in credit strategy is to achieve profitable returns while managing risk within the loan portfolio. Credit strategy and policy are usually determined by senior management and approved by the board of directors.

6.04 The objectives of a sound credit plan are to identify profitable markets, set goals for portfolio growth or contraction, and establish limits on industry and geographic concentrations. The plan establishes the institution's credit underwriting standards. In addition, management procedures and controls are required to monitor loan performance through periodic reporting and review and to identify and monitor problem loan situations.

Credit Risk

6.05 The overriding factor in making a loan is the amount of credit risk associated with the lending process. For individual loans, credit risk pertains to the borrower's ability and willingness to pay; it is assessed before credit is granted or renewed and periodically throughout the loan term.

6.06 An institution's credit exposure may be affected by external factors, such as the level of interest rates, unemployment, general economic conditions, real estate values, and trends in particular industries and markets. Internal factors—such as an institution's underwriting practices, credit practices, training, risk management techniques, familiarity and experience with its loan products and customers, the relative mix and geographic concentration of its loan portfolio, and the strength of its internal control structure—also have a significant effect on an institution's ability to control and monitor its credit exposure.

6.07 Additional risks, however, are involved in the overall credit process, and the institution should assess them when developing credit strategy, defining target markets, and designing proper controls over credit initiation and credit supervision. Those additional risks include the following:

- *Collateral Risk*. The institution may be exposed to loss on collateralized loans if its security interest is not perfected or the collateral is not otherwise under the institution's control, if the value of the collateral declines, or if environmental contingencies impair the value of the collateral or otherwise create liability for the institution.
- *Concentration Risk*. Inadequate diversification of the loan portfolio in terms of different industries, geographic regions, or number of borrowers may result in significant losses. A high concentration of loans to companies in an industry experiencing economic problems, for example, would constitute a concentration risk.
- *Country or Transfer Risk*. Economic, social, legal, and political conditions of a foreign country may unfavorably affect a borrower's ability to repay in the currency of the loan. Cross-border loans are those that borrowers must repay in a currency other than their local currency or to a lender in a different country. Losses may result if a country's foreign exchange reserves are insufficient to permit timely repayment of cross-border loans by borrowers domiciled in that country, even if the borrowers possess sufficient local currency. In addition, foreign government decisions and associated events can affect business activities in a country as well as a borrower's ability to repay its loans.
- *Foreign Exchange Risk*. Changes in foreign exchange rates may affect lenders unfavorably.
- *Fraud Risk*. Loans may expose the institution to loss by not being bona fide transactions.
- *Insider Risk*. Loans to executive officers, directors, and principal shareholders of the institution and related interests of such insiders may expose the institution to loss if these loans are made to related individuals or companies, or both, with little credit history; if they lack an identified source of funds for repayment; or if they are made to newly organized or highly leveraged enterprises with insufficient collateral and inadequate financial information.
- *Interest-Rate Risk*. The maturity and repricing characteristics of loans can have a significant impact on the interest-rate risk profile (and, therefore, interest income) of an institution. For example, an institution that holds primarily fixed-rate loans could be adversely affected by a significant increase in interest rates.
- *Legal and Regulatory Risk*. Illegally granted loans, loans with usurious interest rates, and loans with terms that are not adequately disclosed to the borrower may expose the institution to loss.
- *Management Risk*. Management's competence, judgment, and integrity in originating, disbursing, supervising, collecting, and reviewing loans could substantially affect the collectibility of loans.

- *Operations Risk*. Funds might be disbursed without proper loan authorization, collateral documentation, or loan documentation. Failure of the institution to evaluate and monitor potentially uncollectible loans also constitutes an operations risk.

Lending Policies and Procedures

6.08 Definitive lending policies and comprehensive procedures for implementing such policies can contribute significantly to the institution's internal control structure over financial reporting as it relates to the lending process.

6.09 The lending function can be broadly divided into the categories of (*a*) credit origination and disbursement, (*b*) credit supervision, (*c*) collection, and (*d*) loan review.

6.10 ***Credit Origination and Disbursement.*** Credit origination involves all the processes from the original request for credit to the disbursement of funds to the customer. Specific control features to meet operational—rather than financial reporting—objectives for credit origination usually include the following:

- Credit initiation, that is, obtaining complete and informative loan applications, including financial statements and the intended use of proceeds
- Credit investigation
  - Credit reports or other independent investigations
  - Proper analysis of customer credit information, including determination of projected sources of loan servicing and repayment
- Loan approval (new and renewed loans)
  - Loan approval limits according to officer expertise, administrative authority, or both
  - Committee approval or board of director approval, or both, for loans exceeding prescribed limits
  - Segregation of duties between the loan approval function and the disbursement and collection functions
  - Collateral ownership and control verified, including lien searches and documentation of the priority of security interest
  - Collateral margin determined
- Documentation of credit, or the inspection of supporting documents for proper form, completeness, and accuracy by someone other than the lending officer
- Perfection of collateral interest or proper security filings and recording of liens
- Disbursement of loan proceeds or, to the extent possible, control of disbursement to ensure that proceeds are used for the borrower's stated loan purpose

6.11 ***Credit Supervision.*** Loan officers are responsible for closely monitoring the loans in their portfolios and bringing problem loans to the attention of management. Their duties normally include obtaining and analyzing the borrower's periodic financial statements, reassessing collateral values, making periodic visits to the customer's place of operation, and generally keep-ing abreast of industry trends and developments and of the customer's financial requirements and ability to perform. Management reports concerning loan activity, renewals, and delinquencies are vital to the timely identification of problem loans. Input from loan officers is also important for identifying when loans should be reserved for or charged off. Most institutions have written policies covering the timing of chargeoffs (which may be based on regulatory guidance).

6.12 ***Collection.*** Loans identified as problems under the institution's established criteria should be monitored, restructured, or liquidated, as appropriate. The institution normally attempts to work with the customer to remedy a delinquency. Sometimes the debt is restructured to include terms the customer can satisfy; at other times, the institution obtains additional collateral to support the loan. However, when the loan is delinquent for a specified period of time, as normally defined in the institution's lending policy, the institution may begin legal proceedings such as foreclosure or repossession to recover any outstanding interest and principal.

6.13 ***Loan Review.*** Periodic review by institution personnel of the credit process and of individual loans is essential in assessing the quality of the loan portfolio and the lending process. Loan review preferably should be conducted by personnel who are independent of the credit origination, disbursement, supervision, and collection functions. Depending on the complexity of the organizational structure, these personnel report directly to the board of directors or to senior management. Loan review may be performed by specifically assigned staff or may be incorporated within an internal audit function.

6.14 Loan review includes several distinct activities. The principal emphasis is on determining whether the loan conforms to the institution's written lending policies and is likely to perform in accordance with the agreed-on terms and conditions, including compliance with any restrictive covenants in a loan agreement. The review normally includes analyzing the borrower's financial statements, reviewing performance since origination or last renewal, and determining if sufficient credit information is available to assess the borrower's current financial condition.

6.15 Loan file contents should be reviewed as part of the institution's internal loan review process to determine if credit reports, appraisals, and other third-party information existed before the credit or renewal was granted and if the quality of such information supported, and continues to support, the credit decision. If the loan is secured or guaranteed, the review should also determine that collateral is under control, security interest is perfected, and guarantees have been executed properly. Also, the value of collateral should be estimated at the review date to identify deficiencies in collateral margins.

6.16 Loan review may also identify weaknesses in the lending process or in the lending officers' skill in originating, supervising, and collecting loans. Loan review results should be documented and may be summarized in the form of subjective ratings of individual loans similar to regulatory examination classifications. In addition, loan review may reveal the need for a loss accrual, as discussed in chapter 7.

Types of Lending

6.17 Banks and savings institutions offer a variety of loan products to meet borrowers' needs and as part of their overall credit strategy and asset/liability management strategy. Loans may be made on a line-of-credit, installment, demand, time, or term basis. A brief description of each of those kinds of arrangements follows.

a. *Line-of-Credit Arrangements.* The institution provides the borrower with a maximum borrowing limit for a specified period. Lines of credit may be structured in a variety of ways. Letters of credit, which are commonly used as credit enhancements for other forms of borrowing (such as commercial paper or trade financing), are agreements to lend a specified amount for a specified period (usually less than one year). Revolving credit agreements, which are commonly used in credit-card lending, are agreements to lend up to a specified maximum amount for a specified period, usually more than one year, and provide that repayment of amounts previously borrowed under the agreement are available to the borrower for subsequent borrowing. Repayment schedules may be on an installment, demand, time, or term basis, as discussed below. Other line-of-credit arrangements are applied to—

- *Construction,* where the borrower may draw on the line as necessary to finance building costs to supplement (or pending the securing of) a construction loan.
- *Liquidity,* used by the borrower in overall management of its liquidity needs.
- *Warehousing,* used by borrowers engaged in mortgage banking activities to fund origination of mortgage loans, generally pending sale of the loans to a secondary market investor.

b. *Installment Loans.* These require periodic principal and interest payments. Installment loans may be made on either a simple interest or a discounted basis. The discounted basis means that interest (discount), credit-life insurance premiums, and other charges are generally added to the amount advanced to arrive at the face amount of the note. The discount, called *unearned interest,* is netted against the face amount of the note on the balance sheet and accreted into income over time to achieve a level yield.

c. *Demand Loans.* These have no fixed maturity date, are payable on demand of the lender, and generally have interest rates that change periodically. Demand loans generally require periodic (for example, monthly) interest payments.

d. *Time Loans.* These are made for a specific period of time. Interest is payable periodically, and principal is usually due at maturity. Such loans are often renewed at maturity in what is known as a "rollover." Interest rates, if fixed during the loan period, reprice when the loan is rolled over.

e. *Term Loans.* These are made for a specified term, generally in excess of one year, at a rate of interest that either is fixed or floats based on an independent index, such as the London Interbank Offered Rate (LIBOR), or prime or treasury rates. Repayment schedules are structured in a variety of ways. Some term loans are amortized on a regular installment schedule; others contain provisions for a large portion of the loan to be paid at maturity (a *balloon payment*); and still others may call for installments of irregular size and timing based on cash-flow projections.

6.18 Loans may be categorized in a variety of ways, depending on the institution. Institutions group loans in ways that are meaningful in their particular circumstances; for most, the groupings are based on the kind of borrower and the purpose of the loan. Some common categories of loans include (*a*) commercial, industrial, and agricultural; (*b*) consumer; (*c*) residential real estate; (*d*) lease financing; (*e*) trade financing, (*f*) commercial real estate and construction; and (*g*) foreign.

Commercial, Industrial, and Agricultural Loans

6.19 Despite changes in corporate borrowing practices (and increased competition from other kinds of financial institutions), commercial, industrial, and agricultural loans (sometimes called *C and I* or *business loans*) are an important part of many institutions' business. There are a wide variety of commercial, industrial, and agricultural loans. They include—

- Short-term working capital loans, which are generally used by manufacturing companies to finance the purchase of raw materials and other production needs until the finished goods are sold.
- Asset-based financing, usually secured by current assets such as accounts receivable or inventories.
- Seasonal loans, which are used to provide cash to businesses (such as farms and retailers) during low-revenue periods of the year.
- Floor-plan financing, which is used by automobile and durable goods dealers to finance inventories.
- Long-term working capital loans.
- Loans and leases to finance the purchase of equipment.
- Loans to finance major projects, such as the construction of refineries, pipelines, and mining facilities.

6.20 Large commercial loans may involve more than one lender (see the discussion of loan participations that follows). Commercial loans may be secured (that is, the institution holds a lien against pledged assets, such as securities, inventories, property and equipment, or accounts receivable) or unsecured. Also, such loans may be guaranteed or endorsed by third parties, including agencies of the U.S. government such as the Small Business Administration. Compensating-balance arrangements and commitment fees are often associated with commercial, industrial, and agricultural lending and are important factors in determining the interest rates on such loans. Commercial loans include demand loans, term loans, and line-of-credit arrangements.

Consumer Loans

6.21 Consumer loans are loans to individuals for household, family, and other personal expenditures. Commonly, such loans are made to finance purchases of consumer goods, such as automobiles, boats, household goods, vacations, and education. Interest rates and terms vary considerably depending on many factors, including whether the loan is secured or unsecured. The two most significant kinds of consumer lending are installment loans and revolving credit arrangements (credit-card lending).

6.22 ***Installment Loans.*** Automobile loans with three- to five-year terms are the largest kind of secured installment loan. Consumer installment loans, which are generally secured by the item purchased, may originate directly from an institution's customers (direct paper) or indirectly from a dealer's customers (indirect paper). Indirect loans involve the purchase, often at a discount, of dealer contracts that represent the sale of goods, typically for major purchases such as automobiles. The institution typically retains a portion of the purchase price to be paid to the dealer for the discounted note as a dealer holdback or dealer reserve. The dealer reserve provides protection to the institution in the event that the institution is entitled to payments from the dealer. Depending on the agreement with the dealer, the institution may be entitled to recover losses due to borrower delinquencies, defaults, or prepayments.

6.23 ***Credit Cards.*** Credit-card lending is a major business for many institutions. Institutions may participate in the credit-card market in various ways. Some institutions may issue or make credit cards available directly to customers. Institutions may also sponsor cards that are issued by another institution. The sponsoring institution may take credit applications, perform credit checks, and have its name printed on the cards, but the issuing institution records the consumer loans and assumes the credit risk. Most credit-card lending is on an unsecured basis, although some secured programs exist. Within geographic areas there are service companies that centralize card issuance, process transactions, and maintain customer accounts.

6.24 Credit-card holders receive prenumbered cards under a prearranged line of credit with the institution issuing the card. Though the terms of credit cards vary, an annual fee is often charged for the use of the card and interest is charged on outstanding balances. Cards typically carry a twenty- to thirty-day grace period during which no interest is charged if outstanding balances are paid in full. Furthermore, merchants are generally charged a transaction fee.

6.25 Many institutions that issue credit cards have agreements with one of the two major international bank card systems, Visa and Interbank (MasterCard). However, a number of financial institutions have independent plans. The main functions that the bank card systems perform are enrolling merchant members and providing an authorization system. The main functions that the issuing institutions perform are issuing cards, setting credit limits, billing, collections, and customer service.

6.26 ***Overdraft Protection.*** Another type of revolving credit is overdraft protection on checking accounts. Overdraft protection is an agreement between an institution and its customer to provide a prearranged line of credit that is automatically drawn if the customer writes checks above the amount in his or her deposit account. Interest is charged on amounts outstanding.

Residential Real Estate Loans

6.27 Loans secured by one- to four-family residential property of the borrower are generally referred to as *residential mortgage loans*. Repayment terms for residential mortgage loans may vary considerably. Such loans may be structured to provide for full amortization of principal, partial amortization with a balloon payment at a specified date, or negative amortization.[1] Interest rates may be fixed or variable. Variable-rate loans generally are referred to as adjustable-rate mortgages (ARMs). In addition, institutions may require borrowers in certain circumstances to purchase private mortgage insurance to reduce the institution's credit risk.

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[1] Reverse mortgages also exist, which provide homeowners with monthly payments in return for decreasing equity, wherein the institution may eventually gain ownership of the real estate.

6.28 The Federal Housing Administration (FHA) insures and the Department of Veterans' Affairs (VA) partially guarantees many residential real estate mortgages. The FHA sets minimum down payments and interest rates for FHA loans. FHA-insured borrowers pay an annual insurance premium computed each year on the loan balance at the beginning of the year. The VA guarantee program, which was initiated to enable veterans to obtain homes when they return from military service, provides certain features, including an interest-rate ceiling that is generally lower than prevailing market rates, a partial guarantee to the lender, a low (or no) down payment, and a prohibition against mortgage brokers' commissions. Residential mortgage loans that are not FHA-insured or VA-guaranteed are called *conventional loans*.

6.29 Chapter 8 includes further discussion of residential real estate loans.

Lease Financing

6.30 Institutions also may be involved in direct lease financing, in which an institution owns and leases personal property for the use of its customers at the customers' specific request. A typical lease agreement contains an option providing for the purchase of the leased property, at its fair value or at a specified price, by the lessee at the expiration of the lease. Such leases may be financing transactions (see paragraph 6.64).

6.31 Institutions may also engage in a specialized form of lease financing, known as *leveraged leasing*, in which the institution acts as an equity participant. In this type of lease, a substantial portion of the purchase price of the asset is supplied by unaffiliated long-term lenders on a nonrecourse basis. The lease may be for the purpose of achieving certain tax benefits for the institution.

Trade Financing

6.32 Trade financing is a specialized area of commercial lending frequently used by businesses that engage in international activities. Such financing includes open account financing, sales on consignment, documentary collections, advances against collections, letters of credit, bankers' acceptances, factoring, and forfeiting. Banks and savings institutions charge fees for such arrangements. The most commonly used of these arrangements is the letter of credit.

6.33 The two primary types of letters of credit are the commercial letter of credit and the standby letter of credit. A commercial letter of credit represents a commitment by a bank or savings institution (the issuing institution) to make payment for a specified buyer (the importer) to a specified seller (the exporter) in accordance with terms stated in the letter of credit. Under a standby letter of credit, the issuing institution guarantees that the buyer will make payment. The issuing institution is not ordinarily expected to make payment; however, if it does make payment, the buyer is obligated under the agreement to repay the institution. Standby letters of credit are also used to guarantee the performance of U.S. companies under contracts with foreign corporations and foreign or domestic governments. Depending on the nature of the agreement, these transactions may involve a high degree of credit risk.

Commercial Real Estate and Construction Loans

6.34 Loans made on real property such as office buildings, apartment buildings, shopping centers, industrial property, and hotels are generally referred to as commercial real estate loans. Such loans are usually secured by mortgages or other liens on the related real property. Repayment terms on commercial real estate loans vary considerably. Interest rates may be fixed or variable, and the loans may be structured for full, partial, or no amortization of principal (that is, periodic interest payments are required and the principal is to be paid in full at the loan maturity date). Some give the institution recourse to third parties, who guarantee repayment of all or a portion of the loans. Others are nonrecourse, that is, if the borrower cannot repay the loan, the lender has only the collateral as a source of repayment—the lender does not have recourse to any other source of repayment.

6.35 Construction lending involves advances of money from a bank or savings institution to finance the construction of buildings or the development of raw land. The institution generally agrees to a specified loan amount, part of which will be disbursed to the borrower at the inception of the project and part of which will be disbursed as construction progresses, based on specified milestones that were agreed to by the institution and the borrower. Construction loans are generally made for the construction period only, which generally runs from one to seven years. Often, both interest and principal are payable at maturity. After construction is completed, the borrower usually obtains long-term mortgage financing from another financial institution. Large commercial real estate and construction loans may involve more than one lender (see paragraph 6.38).

6.36 Certain real estate loan arrangements, in which the lender has virtually the same risks and potential rewards as those of the owners of the property, should be considered and accounted for as investments in real estate.[2] Certain real estate acquisition, development, and construction (ADC) arrangements that should be accounted for as investments in real estate are discussed in chapter 9.

Foreign Loans

6.37 Foreign (or cross-border) loans are made primarily by larger institutions and consist of loans to foreign governments, loans to foreign banks and other financial institutions, and commercial and industrial loans. Foreign loans also include consumer and commercial lending, including real estate loans, made by foreign branches. Such loans may contain certain risks, not associated with domestic lending, such as foreign exchange and country or transfer risks, as described in paragraph 6.07. This type of lending exposes the institution to cross-border risk, which is the possibility that the borrowing country's exchange reserves are insufficient to support its repayment obligations.

Loans Involving More Than One Lender

6.38 Institutions sometimes receive requests for loans that exceed the institution's capacity or willingness to lend. In response, shared lending arrangements were created. In a syndication lending arrangement, groups of institutions agree to participate in a particular loan, with each institution being

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[2] In July 1994, the Accounting Standards Executive Committee (AcSEC) considered a final draft of a proposed Statement of Position (SOP), *Identifying and Accounting for Real Estate Loans That Qualify as Real Estate Investments*. At that time, there was not sufficient support to issue the final Statement and AcSEC is discussing various alternatives. Readers should be alert to the issuance of any final Statement.

a direct creditor of the borrower but with uniform lending terms applied by all the institutions. One institution is typically appointed as the agent, or lead institution, having primary responsibility for communication and negotiation with the borrower. The lead institution may also service all loans in the group. In a participation lending arrangement, a lead institution originates a loan for the entire amount and sells to other lenders (participating institutions) portions of the loan it originated. The lead institution disburses all funds, supervises the perfection of legal interests in the underlying collateral, and usually services the loan. Loan participations may be negotiated on either a recourse or nonrecourse basis. Also, a participation may be sold on terms that differ from the original loan terms.

6.39 In a loan syndication, the participating institutions arrange a lending syndicate in which the lead syndicator and participants in the syndication fund their respective portions of the loan. A syndication typically involves less risk to a lead institution than a participation because the lead institution funds only its portion—rather than the entire amount—of the loan at origination.

Regulatory Matters

Real Estate Lending Standards

6.40 The agencies have established real estate lending standards and related guidelines that describe the factors management should address in its real estate lending policies.[3] Each institution is required to adopt and maintain written policies that establish limits and standards for extensions of credit related to real estate. The lending policies must establish—

a. Portfolio diversification standards.

b. Underwriting standards, including loan-to-value (LTV) ratio limitations.

c. Loan administration policies.

d. Documentation, approval, and reporting requirements to monitor compliance and appropriateness.

6.41 Management's policies are to be appropriate to the size of the institution and the nature and scope of its operation, and the board of directors of the institution is to review and approve the policies at least annually.

6.42 In supplementary guidelines, the agencies outline considerations for loan portfolio management, underwriting standards, loan administration, LTV ratios, and policy exceptions. (See Office of the Comptroller of the Currency [OCC] Banking Bulletin 92-75.)

Appraisals

6.43 The agencies require an appraisal by a certified or licensed appraiser for real estate-related financial transactions (as defined) having a value of $250,000 or greater. The appraisal rules exempt certain transactions.[4]

Income Recognition on Problem Loans

6.44 Following issuance of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*, the Federal Fi-

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[3] See Title 12 of the Code of Federal Regulations (12 CFR), Parts 34 (OCC); 225 (FRB); 323 (FDIC); and 545, 563, and 564 (OTS).

[4] See footnote 3 in this chapter.

nancial Institutions Examination Council (FFIEC) announced it would retain its existing nonaccrual policies governing the recognition of interest income.[5]

Accounting and Financial Reporting

6.45 Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff should be reported in the balance sheet at outstanding principal adjusted for any chargeoffs, the allowance for loan losses, any deferred fees or costs on originated loans, and any unamortized premiums or discounts on purchased loans. (Chapter 7 deals with the allowance for loan losses.)

6.46 Mortgage loans held for sale should be reported at the lower of cost or market value in conformity with FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*. Other loans held for sale should be reported at the lower of cost or market value. Mortgage-backed securities held for sale in conjunction with mortgage banking activities should be classified as trading securities and reported at fair value in conformity with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

Interest Income

6.47 Interest income on loans that are not impaired should be accrued and credited to interest income as it is earned, using the interest method. Disclosures about the recorded investment in certain impaired loans and about how a creditor recognizes interest income related to those impaired loans are established in FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, as amended by FASB Statement No. 118.

Loan Fees, Costs, Discounts, and Premiums

6.48 FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, establishes the accounting for loan origination fees and costs.[6] In general, loan origination fees net of direct loan origination costs should be deferred and recognized over the contractual life of the loan as an adjustment of yield using the interest method. However, for certain homogeneous pools of loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the institution may consider estimates of prepayments in the calculation of the constant effective yield necessary to apply the interest method. Direct loan origination costs include only incremental direct costs incurred in transactions with independent third parties and certain costs directly related to specified activities performed by the lender. Deferred costs include only the direct costs of completed loans and must be deferred irrespective of the existence of related loan fees. Direct costs of unsuccessful loan origination efforts and all indirect costs are charged to expense as incurred.

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[5] The announcement was published in the *Federal Register* on February 10, 1995.

[6] The staff of the FASB has also published a FASB Special Report, *A Guide to Implementation of Statement 91 on Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases: Questions and Answers*.

6.49 FASB Statement No. 91 requires that fees received for a commitment to originate or purchase a loan or group of loans should be deferred except for certain retrospectively determined fees. If the commitment is exercised, the commitment fee should be recognized as an adjustment of yield over the related loan's life. If the commitment expires unexercised, the commitment fee should be recognized in income upon expiration of the commitment. However, commitment fees for which the likelihood of exercise is remote should be recognized over the loan commitment period on a straight-line basis.

6.50 FASB Statement No. 91 considers that for purchased loans, the initial investment includes the amount paid to the seller, net of fees paid or received. All other costs related to the purchase of loans are charged to expense as incurred. Premiums and discounts on purchased loans are recognized as an adjustment of yield over the contractual life of the loan. If the institution holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, paragraph 19 of FASB Statement No. 91 allows the institution to consider estimates of future principal prepayments in calculation of the constant effective yield necessary to apply the interest method.

6.51 Paragraph 12 of FASB Statement No. 91 requires that the accounting for net fees or costs related to refinancings or restructurings (other than troubled debt restructurings) be based on whether the terms of the new loan are at least as favorable to the lender (based on effective yield) as the terms of comparable loans. FASB Statement No. 91 also discusses a variety of other amortization issues, including the treatment of increasing-, decreasing-, and variable-rate loans as well as demand loans and revolving lines of credit.

6.52 Discussion by the FASB's Emerging Issues Task Force (EITF) of Issues No. 88-20, *Difference Between Initial Investment and Principal Amount of Loans in a Purchased Credit Card Portfolio*, No. 92-5, *Amortization Period for Net Deferred Credit Card Origination Costs*, No. 93-1, *Accounting for Individual Credit Card Acquisitions*, and No. 88-17, *Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations*, provide related guidance.

Amortization of Discounts on Certain Acquired Loans

6.53 AcSEC issued AICPA Practice Bulletin 6, *Amortization of Discounts on Certain Acquired Loans*, in 1989 to provide guidance on the accounting and reporting by purchasers of certain acquired loans or other debt securities (as defined).[7] For acquired loans or other debt securities within its scope, Practice Bulletin 6 includes guidance on (*a*) amortization of discounts that reflect impairment due to credit risk, (*b*) initial and subsequent recognition of principal and interest, and (*c*) assessing collectibility. Practice Bulletin 6's provisions on these issues are inconsistent with certain provisions of FASB Statements No. 114, as amended by FASB Statement No. 118 (and related amendments of FASB Statements No. 5, *Accounting for Contingencies*, and No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*) and FASB Statement No. 115. AcSEC is considering actions that it should take on Practice Bulletin 6; however, FASB Statements No. 114, No. 115, and No. 118 take precedence for loans and debt securities within their scope. Readers should be alert to any final action on Practice Bulletin 6.

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[7] Related financial reporting by liquidating banks is beyond the scope of Practice Bulletin 6 and was addressed in EITF Issue No. 88-25, *Ongoing Accounting and Reporting for a Newly Created Liquidating Bank*.

Troubled Debt Restructurings

6.54 FASB Statement No. 15, as amended by FASB Statements No. 114 and No. 121, *Accounting for Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, establishes the accounting for troubled debt restructurings (TDRs). For creditors, TDRs include certain modifications of terms of loans and receipt of assets from debtors in partial or full satisfaction of loans.

6.55 Outstanding loans whose terms have been modified in TDRs are accounted for under the provisions of FASB Statement No. 114, as amended by FASB Statement No. 118.

6.56 ***Modifications of Terms.*** Paragraph 5(c) of FASB Statement No. 15 says that modifications of terms of debt may include one or a combination of the following:

a. Reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt

b. Extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk

c. Reduction (absolute or contingent) of the face amount or maturity amount of the debt as stated in the instrument or other agreement

d. Reduction (absolute or contingent) of accrued interest

Creditors should account for modifications of terms of loans in accordance with FASB Statements No. 15 and No. 114.

6.57 ***Receipts of Assets.*** Paragraph 28 of FASB Statement No. 15, as amended by paragraph 24 of FASB Statement No. 121, says:

> A creditor that receives from a debtor in full satisfaction of a receivable either (i) receivables from third parties, real estate, or other assets or (ii) shares of stock or other evidence of an equity interest in the debtor, or both, shall account for those assets (including an equity interest) at their fair value at the time of the restructuring (see paragraph 13 [of FASB Statement No. 15] for how to measure fair value). A creditor that receives long-lived assets that will be sold from a debtor in full satisfaction of a receivable shall account for those assets at their fair value less cost to sell as that term is used in paragraphs 15-17 of [FASB Statement No. 121]. The excess of (i) the recorded investment in the receivable satisfied over (ii) the fair value of assets received (less cost to sell, if required above) is a loss to be recognized. For purposes of this paragraph, losses, to the extent they are not offset against allowances for uncollectible amounts or other valuation accounts, shall be included in measuring net income for the period. [*Footnotes omitted.*]

6.58 Paragraphs 9.08 and following discuss the accounting for and reporting of foreclosed assets established by FASB Statements No. 15 and No. 121, and AICPA SOP 92-3, *Accounting for Foreclosed Assets*.

6.59 Paragraph 34 of FASB Statement No. 15, as amended by FASB Statement No. 114, requires that:

> A troubled debt restructuring that is in substance a repossession or foreclosure by the creditor, that is, the creditor receives physical possession

> of the debtor's assets regardless of whether formal foreclosure proceedings take place, or in which the creditor otherwise obtains one or more of the debtor's assets in place of all or part of the receivable, shall be accounted for according to the provisions of paragraphs 28 and 33 and, if appropriate, 39.

Paragraphs 28 and 33 of FASB Statement No. 15 are described in paragraphs 6.57 and 6.60 herein, respectively. Paragraph 39 of FASB Statement No. 15 says:

> A receivable from the sale of assets previously obtained in a troubled debt restructuring shall be accounted for according to *APB Opinion No. 21* regardless of whether the assets were obtained in satisfaction (full or partial) of a receivable to which that Opinion was not intended to apply. A difference, if any, between the amount of the new receivable and the carrying amount of the assets sold is a gain or loss on sale of assets.

6.60 ***Combination of Types.*** For TDRs involving receipt of assets (including an equity interest) in partial satisfaction of a receivable and a modification of terms of the remaining receivable, paragraph 33 of FASB Statement No. 15, as amended by FASB Statement No. 121, requires that the assets received should be accounted for as prescribed in paragraph 28 of the Statement (see paragraph 6.57) and the recorded investment in the receivable should be reduced by the fair value less cost to sell of the assets received.

6.61 FASB Technical Bulletin No. 94-1, *Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring*, clarifies that any loan that was restructured in a TDR involving a modification of terms, including those restructured before the effective date of FASB Statement No. 114, would be subject to the provisions of FASB Statement No. 115 if the debt instrument meets the definition of a security (as provided in FASB Statement No. 115).

6.62 EITF Issue No. 94-8, *Accounting for Conversion of a Loan into a Debt Security in a Debt Restructuring*, discusses how to account for the difference between the recorded investment in a loan being restructured and the fair value of debt securities received at the time of conversion.

Real Estate Investments

6.63 The AICPA's Notice to Practitioners on ADC arrangements[8] requires that certain loans be accounted for as investments in real estate or real estate joint ventures, rather than as loans in situations where the bank or savings institution has taken on virtually the same risks and potential rewards as an owner. Loans that are accounted for as real estate investments or joint ventures should not be reported or accounted for as loans and are usually classified in other assets or other real estate owned (see chapter 9).

Lease Financing

6.64 Accounting for leases by lessees and lessors is established by FASB Statement No. 13, *Accounting for Leases*, as amended by FASB Statement No.

[8] The Notice appears as exhibit I in AICPA Practice Bulletin 1, *Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance.* (See footnote 2 in this chapter.)

98, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, Initial Direct Costs of Direct Financing Leases*. Other interpretive pronouncements address additional circumstances.

Foreign Loans

6.65 Accounting for foreign loans is generally the same as for single-jurisdiction, domestic loans. However, unique issues arise regarding the accounting for restructured debt of developing countries and the recognition of interest income on such loans.

6.66 AICPA Practice Bulletin 4, *Accounting for Foreign Debt/Equity Swaps*, was issued in 1988 to address exchanges of public- or private-sector loans to debtors in financially troubled countries for equity investments in companies in the same countries. Such transactions are referred to as *debt/equity swaps*. In a typical debt/equity swap, holders of U.S. dollars-denominated debt of a particular country convert that debt into approved equity investments in that country, based on the official exchange rate at the time of the transaction. A discount from the official exchange rate is usually charged on the transaction. Such debt/equity swaps are considered exchanges of monetary assets for nonmonetary assets, which should be accounted for at fair value at the date on which both parties agree to the transaction. Because prices in the secondary markets for the debt of financially troubled countries may not be the best indicator of value, Practice Bulletin 4 also provides guidance on determining fair values of debt/equity swap transactions.

6.67 AICPA Practice Bulletin 5, *Income Recognition on Loans to Financially Troubled Countries*, was issued in 1988 to address whether an institution should credit receipt of interest payments on nonaccrual loans to the principal balance of the loan or to income when the loan has been placed on nonaccrual status.

Commitments

6.68 Commitments to originate loans in the ordinary course of business generally have no immediate accounting effect, though institutions should consider such commitments when evaluating the liability for other credit exposures. However, commitments should be disclosed in the notes to the financial statements. (Chapter 8 addresses commitments to sell loans.) (Paragraphs 7.26 and following address accounting for loss contingencies in conformity with FASB Statement No. 5.)

6.69 Banks and savings institutions sometimes enter into forward standby commitments to purchase loans at a stated price in return for a standby commitment fee. In such an arrangement, settlement of the standby commitment is the option of the seller and results in delivery only if the contract price exceeds the market price of the underlying loan or security on the settlement date. A standby commitment differs from a mandatory commitment in that the institution assumes all the market risks of ownership but shares in none of the rewards. A standby commitment is, in substance, a put option. Many institutions use standby commitments to supplement their normal loan origination volume. If the settlement date is within a reasonable period (for example, a normal loan commitment period) and the institution has the intention and ability to accept delivery without selling assets, standby commitments are generally viewed as part of the normal production of loans, and institutions record loans purchased under standby commitments at cost on the settlement date and amortize the standby commitment fee over the estimated life of the loans, in conformity with FASB Statement No. 91. However, if the settlement date is not within a reasonable period or the institution does not have the intention and ability to accept delivery without selling assets, the standby commitment generally is accounted for as a written put option. In that case, the option premium received (standby commitment fee) should be recorded as a liability representing the unrealized loss of the standby commitment on the trade date. Thereafter, the liability should be accounted for at the greater of the fee or unrealized loss. Unrealized gains (that is, recoveries of unrealized losses) or losses should be credited or charged to current operations.

6.70 Fixed-rate loan commitments and certain variable-rate loan commitments have characteristics similar to options and, therefore, fall within the scope of FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*. The requirements of FASB Statement No. 119 are discussed in paragraphs 15.84 and following.

Financial Statement Presentation and Disclosure

6.71 Management's disclosure in the summary of significant accounting policies should include—

- The basis of accounting for loans and lease financings, both held in a portfolio and held for sale.
- The method of determining carrying amounts of loans held for sale (required for mortgage loans by paragraph 29 of FASB Statement No. 65).
- The methods and significant assumptions used to estimate the fair value of loans (as required by paragraph 10 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*).
- The method of estimating credit losses (see chapter 7).
- The method of recognizing interest income on loans, including a statement about the institution's policy for the treatment of loan fees and costs, including the method of amortizing net deferred fees or costs. This disclosure should include the institution's policy for recognizing interest income on impaired loans, including how cash receipts are recognized (as required by paragraph 20 of FASB Statement No. 114, as amended by FASB Statement No. 118).

6.72 Loans are typically presented on the balance sheet as an aggregate amount. However, loans held for sale should be a separate balance-sheet category. Major categories of loans should be presented separately either in the balance sheet or in the notes to the financial statements. The allowance for credit losses, unearned income, unamortized premiums and discounts, and net unamortized deferred fees and costs should be disclosed in the financial statements. Also, the undisbursed portion of loans receivable (loans in process) should be disclosed. In addition, loans that have been restructured in a TDR should be separately disclosed.

6.73 The total carrying value of loans pledged as collateral for borrowings should be disclosed.

6.74 FASB Statement No. 13 requires certain disclosures by lessors when leasing is a significant part of a lessor's business activities in terms of revenue, net income, or assets.

6.75 FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, as amended by FASB Statement No. 119, requires disclosure of (*a*) the extent, nature, and terms of financial instruments with off-balance-sheet risk (paragraph 17); (*b*) credit risk of financial instruments with off-balance-sheet credit risk (paragraph 18); and (*c*) concentrations of credit risk of all financial instruments (paragraph 20). The disclosure requirements set forth in paragraph 17 of FASB Statement No. 105 similarly are required for financial instruments without off-balance-sheet risk by paragraph 8 of FASB Statement No. 119. Examples of financial instruments with off-balance-sheet risk discussed in this chapter include loans sold with recourse (with or without a floating-interest-rate provision), fixed-rate and variable-rate loan commitments, financial guarantees, note issuance facilities at floating rates, and letters of credit.

6.76 FASB Statement No. 107 as amended by FASB Statement No. 119, requires disclosure of the fair value of financial instruments for which it is practicable to estimate that value. Paragraph 11 of FASB Statement No. 107 says, in part, that

> Quoted market prices, if available, are the best evidence of the fair value of financial instruments. If quoted market prices are not available, management's best estimate of fair value may be based on the quoted market price of a financial instrument with similar characteristics or on valuation techniques.

6.77 Paragraph 26 of FASB Statement No. 107 says, in part, that

> If no quoted market price exists for a category of loans, an estimate of fair value may be based on (*a*) the quoted market price of a financial instrument with similar traded loans with similar credit ratings, interest rates, and maturity dates, (*b*) current prices (interest rates) offered for similar loans in the institution's own lending activities, or (*c*) valuations obtained from loan pricing services offered by various specialist firms or from other sources.

6.78 If it is not practicable to estimate the fair value of a financial instrument or a class of financial instruments, FASB Statement No. 107 requires the disclosure of (*a*) information pertinent to estimating the fair value of that financial instrument or class of financial instruments, such as the carrying amount, effective interest rate, and maturity, and (*b*) the reasons why it is not practicable to estimate fair value.

6.79 FASB Statement No. 57, *Related Party Disclosures*, contains guidance on disclosures about transactions with various related parties. Banks and savings institutions frequently make loans to directors, officers, employees, and stockholders, as well as to entities with which directors, officers, employees, and stockholders are affiliated, in the normal course of business and subject to certain regulatory restrictions. The aggregate amount of such loans should be disclosed.

6.80 Institutions often disclose other information, such as maturities for significant categories of loans and the amounts of loans at fixed and variable rates of interest. Institutions often also disclose commitments to lend additional funds to debtors whose loans are not performing.

6.81 Accounting and financial reporting matters related to sale or other dispositions of loans are addressed in chapter 8.

Auditing

Objectives

6.82 The primary objectives of audit procedures in the loan area are to obtain reasonable assurance that—

a. Loans exist and are owned by the institution as of the balance-sheet date.

b. The allowance for credit losses is adequate for estimated losses inherent in the loan portfolio. (Audit procedures to satisfy this objective are discussed in chapter 7.)

c. Loans are properly classified, described, and disclosed in the financial statements, including fair values of loans and concentrations of credit risk.

d. Recorded loans include all such assets of the institution and the financial statements include all related transactions during the period.

e. Loan transactions are recorded in the proper period.

f. Loans held for sale are properly classified and are stated at the lower of cost or market value.

g. Interest income, fees, and costs and the related balance-sheet accounts (accrued interest receivable, unearned discount, unamortized purchase premiums and discounts, and unamortized net deferred loan fees or costs) have been properly measured and recorded.

h. Gains and losses on the sale of loans have been properly measured and properly recorded.

i. Credit commitments, letters of credit, guarantees, recourse provisions, and loans that collateralize borrowings are properly disclosed in the financial statements.

Planning

6.83 In planning the audit, the independent accountant should consider factors influencing inherent risk, which are described in chapter 3, as they relate to financial statement assertions about loans. As described earlier in this chapter, credit risk is normally the principal risk inherent in lending.

6.84 The composition of an institution's loan portfolio, which can vary widely from institution to institution, is one of the most important factors in assessing inherent risk related to loans. For example, the risks associated with construction lending are very different from the risks associated with credit-card lending. The current year's interim financial statements and other financial information (for example, board of directors' minutes, asset-classification reports, credit management reports, and reports of the institution's regulators) should be helpful in understanding an institution's credit strategy and loan portfolio characteristics and, thereby, in assessing the related inherent risk. Those reports generally include information about such items as dollar amounts and types of loans; the volume of current originations by type and related net deferred loan fees or costs; identification of TDRs; ADC arrangements; purchases and sales of loans, including gains and losses; and wash sales, among others. The independent accountant should consider discussing this information with management and inquiring about other business developments affecting the institution that affect inherent risk in this area.

6.85 The following factors related to loans may be indicative of higher inherent risk (and, often, higher control risk) for loans and related amounts:

- Adverse economic factors and trends
- High rate of growth in the loan portfolio
- Concentration of lending authority in one individual
- Lack of personnel with skills and knowledge of a particular kind of loan, such as credit card or construction
- Significant changes in the composition of an institution's portfolio
- Absence of a loan loss methodology that considers all conditions that might affect the borrowers' ability to repay or, otherwise, the institution's ability to collect
- Poor loan documentation
- Poor recordkeeping and monitoring of principal and interest receipts
- Significant nontraditional lending activities that involve a higher degree of risk, such as highly leveraged lending transactions
- Significant originations or purchases of loans outside the institution's normal activities or market area
- Sales of loans with significant recourse provisions
- Ambiguous transactions involving the sale or transfer of loans, especially when there is a lack of analysis prior to the transactions
- Failure of personnel to follow management's written lending policies for underwriting and documentation
- Loans that are continuously extended, restructured, or modified
- Loans that are of a type, customer, collateral, industry, or geographical location not authorized by management's written lending policies
- Loans secured by collateral the value of which has dramatically decreased recently, especially loans to a related party
- Loans secured by collateral for which the fair value of the collateral is not readily determinable or for which recent appraisals have not been obtained
- Loans secured by collateral for which the borrower does not have good title or for which the lender has not perfected its rights
- Loans of unusual size or with unusual interest rates or terms
- Reluctance of management to recognize problem loans
- Lack of information needed to manage the loan portfolio and make business decisions
- With respect to commercial loans, infrequent monitoring of borrowers' financial condition
- A large number or balance of classified loans (see chapter 7)
- Failure to carry out internal review and credit classification of loans, including failure to identify problem loans in an accurate and timely manner
- Wash sale transactions
- Lack of a formal written lending policy (see paragraph 6.08)
- Significant concentrations of loans in a particular industry or geographic area
- Loans secured by commercial real estate for which a significant number of leases are due to expire

- Significant lending activity that is inconsistent with management's stated strategy
- The potential for insider abuse because of significant loans to the institution's officers, directors, shareholders, or other related parties that do not meet normal underwriting standards, such as nominee loans, loans with questionable collateral, and multiple transactions with a single related party or group of affiliated parties.

Internal Control Structure Over Financial Reporting and Possible Tests of Controls

6.86 As discussed in chapter 3, Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), requires that the independent accountant obtain an understanding of the control environment, the accounting system, and control procedures relating to lending activities sufficient to plan the audit.[9] An understanding of the internal control structure over financial reporting of loans should include controls over transactions such as granting credit, disbursing loan funds, applying loan payments, amortizing discounts, and accruing interest income as those transactions relate to each significant type of lending activity.

6.87 An effective internal control structure over financial reporting in this area should provide reasonable assurance that errors or irregularities in management's financial statement assertions about the loan portfolio—including those due to failure to execute lending transactions in accordance with management's written lending policies—are prevented or detected.

6.88 Because compliance with a well-defined lending policy is essential to an institution's asset quality, failure to follow that policy could have a substantial impact on the reliability of financial statement assertions. For example, authority limits established in management's written underwriting policies are based in large part on (*a*) the knowledge and skill of the reviewing loan officer or committee and (*b*) the credit risk the institution is willing to assume on a particular type of loan. A loan made for an amount in excess of an officer's limit, or for an unauthorized loan type, would normally involve greater amounts of credit or other risks. Accordingly, management's financial statement assertions about the valuation of the loan portfolio, for example, may be affected. An effective internal control structure should provide reasonable assurance that the valuation assertion is fairly presented.

6.89 The internal control structure should also prevent or detect errors or irregularities in the financial statement assertions due to failure to follow management's written policies for loan documentation. For example, failure to

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[9] In December 1995, the Auditing Standards Board (ASB) issued SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards,* vol. 1, AU sec. 319). SAS No. 78 revises the definition and description of internal control contained in the SASs to recognize the definition and description contained in *Internal Control—Integrated Framework* published by the Committee of Sponsoring Organizations of the Treadway Commission. SAS No. 78 is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted.

In conjunction with SAS No. 78, the ASB issued Statement on Standards for Attestation Engagements (SSAE) No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2* (AICPA, *Professional Standards,* vol. 1, AT sec. 400). SSAE No. 6 conforms the description of elements of an entity's internal control to the components of internal control contained in SAS No. 78 and the *Internal Control—Integrated Framework*. SSAE No. 6 is effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, with earlier application permitted.

document a second lien as required by management's written loan documentation policy could affect financial statement assertions about ownership and valuation. An effective internal control structure should provide reasonable assurance that those assertions are fairly presented.

6.90 Factors that contribute to an effective control environment may include—

- A board of directors that takes an active role in monitoring lending policies and practices.
- A well-defined lending approval and review system that includes established credit limits, limits and controls over the types of loans made, limits on maturities of loans, and policies on interest rates and fees charged.
- A reporting system that provides the institution with the information needed to manage the loan portfolio and make business decisions.
- A loan review function that identifies and evaluates existing and potential problem loans in a timely manner.

6.91 During planning, the independent accountant should obtain knowledge about the institution's accounting system as it relates to loans receivable, including the methods used by the institution when processing and recording new loans, applying loan payments, accruing interest, and amortizing discounts.

6.92 In addition, the auditor should obtain knowledge about the control policies and procedures that management has established to provide reasonable assurance that specific financial reporting objectives will be achieved. Typical internal control structure policies and procedures relating to loans include the following:

- All loans and credit lines (including all new loans, renewals, extensions, and commitments) are approved by officers or committees in conformity with management's written lending policies and authority limits.
- Approvals are based on any credit investigations and evaluations required by management's written policy that have been performed prior to extending the credit.
- An inventory of required loan documents, including evidence of collateral and of the recording of liens, is monitored to ensure timely receipt of required documents.
- Pertinent loan information is entered into the data-processing system on a timely basis and is independently tested to ensure accuracy.
- Subsidiary ledgers and trial balances are maintained and reconciled with the general ledger on a timely basis, differences found are investigated and resolved, and appropriate supervisory personnel review and approve completed reconciliations on a timely basis.
- Loans held for sale are properly identified.
- Payments due for principal or interest are monitored for their eventual receipt, aging of delinquencies, and follow-up with late payers.
- There is segregation of duties among those who *(a)* approve loans, *(b)* control notes and collateral, *(c)* receive payments, *(d)* post subsidiary ledgers, and *(e)* reconcile subsidiary and general ledgers.
- Outstanding loans and the related accrued interest receivable are periodically reviewed for collectibility and adequacy of collateral, based on detailed, timely credit investigations and evaluations.

- Appropriate personnel periodically review collateral valuations.
- Procedures are periodically performed to ensure that interest income is properly accrued and recorded.
- Notes and collateral on hand are kept in secure, locked, fireproof compartments. Negotiable collateral is kept under dual access control.
- Construction loan advances are documented to be captured for financial reporting purposes, and periodic on-site inspections of properties are made to ensure the accuracy of those reported amounts that are based on construction progress.

6.93 ***Loan Files.*** Complete and accurate loan files are an element of the internal control structure over financial reporting of loans. Paragraph 6.95 details information that may be found in a loan file. The contents of the files vary, depending on the type of loan, the requirements of local law, and whether the institution intends to hold the loan or not. However, all loan files should generally contain a signed note. An inspection of the files supporting loans originated in prior audit periods, as well as new loans (including some of the loans still in the process of disbursement), generally permits the independent accountant to understand the institution's internal control structure in this area as a basis for planning substantive tests. It may also be useful to design dual-purpose tests in this area.

6.94 For commercial loans, a credit file is commonly maintained. This file usually contains the borrower's financial statements, memoranda about the borrower's financial or personal status, financial statements of guarantors (individual or corporate), internally prepared analyses of the credit, copies of supplemental agreements between the institution and the borrower, and other loan-related correspondence.

6.95 Files supporting either direct or indirect installment loans should generally include the borrower's application, discount sheet (loan computations), credit information, title or financing statement, evidence of the existence of an in-force insurance policy payable to the institution, and the note. Credit files are also maintained on dealers from whom the institution has purchased loan paper.

6.96 Mortgage loan files generally include, but are not necessarily limited to, the note, loan application, appraisal report, verifications of employment and assets, deed of trust, mortgage, title insurance or opinion, insurance policy, settlement statement, and VA guarantee or FHA insurance, if applicable.

6.97 Following are items a loan file typically contains. The location of the contents listed will vary from one institution to another depending on the particular institution's policies and procedures.

a. *Credit Investigation / Application / Supervision Section*

(1) Loan application

(2) Credit approval document that summarizes—
- Borrower.
- Amount of request/rate/payment terms/fees.
- Purpose.
- Repayment sources (primary and secondary).
- Collateral description and valuation.

- Guarantors.
- Other conditions/requirements of approval.

(3) Evidence of loan committee or other required approval and date approval was granted

(4) Financial statements of borrower, guarantor, or both

(5) Spreadsheets and other analyses of the financial situation of the borrower

(6) Borrower's board resolutions concerning loan approval

(7) Credit agency reports and other account information reports, as well as direct trade creditor references

(8) Newspaper clippings about borrower

(9) Various other pertinent data, including the borrower's history and forecasts

(10) Internal memoranda

(11) Correspondence

(12) Loan summary sheet, containing information such as—
- Lending committee approval date.
- Drawdown amounts and dates.
- Interest rates and adjustment dates.
- Amount of undrawn commitment.
- Rate of commitment fee and due dates.
- Date commitment fee received.
- Repayment terms.
- Name of country risk.
- Name and country of any guarantor.
- Amount of participation fee (if applicable).
- Indication of overdue payments of interest, fees, or installments.

(13) Memorandum to the file, by the lending officer, with description of the credit and commentary on its quality and potential future developments

b. Loan Documents Section

(1) Signed loan agreement

(2) Legal opinion

(3) Signed note

(4) Signed mortgage or deed of trust, with evidence of recordation

(5) Signed guarantee

(6) Periodic report of collateral, including its location and value and any related environmental studies

(7) Participation certificates and participation agreements (if applicable)

(8) Evidence of insurance, including loss payable clauses that protect the bank's interest

(9) Approvals

(10) Security agreements or other collateral pledge agreements, titles, or financing statements recorded in proper jurisdictions to perfect lien position (nonpossessory collateral), negotiable collateral (such as stocks and bonds) with proper endorsements/assignments, hypothecation agreement for third-party pledge of collateral

(11) Collateral ledger used to record the instruments (including stocks and bonds, which are probably kept in a vault separate from loan files or with an independent custodian) that secure a borrower's indebtedness

6.98 ***Credit-Card Activities.*** If the institution is involved in all phases of credit-card operations, including credit-card issuance and processing of transactions, the independent accountant should consider the internal control structure over financial reporting of credit-card activities. Audit procedures for testing financial statement assertions related to credit-card activities depend on the degree of the institution's involvement in such activities. If the institution assumes the customer receivables, a review of lending policies, confirmation of customer balances, and tests of interest and service charges, collections, delinquencies, and chargeoffs may be appropriate. If the institution simply processes merchants' deposits and the resulting receivables are assumed by other institutions, a review of the arrangements and a test of service fee income is generally performed.

6.99 Specific procedures the independent accountant should consider performing to test the operating effectiveness of internal control policies and procedures for loans include—

- Inspecting loan documents to determine whether the institution's lending policies and procedures are being followed, for example, to test whether loans are being approved by authorized officers or committees in accordance with the institution's lending policies, whether credit investigations are performed, whether credit limits are adhered to, whether the institution's procedure to capture all required loan documents is functioning, and whether the information recorded in the institution's data-processing system and used for management reporting is being tested by personnel independent of the preparer and is accurate.
- Testing the institution's reconciliation process. This might include the daily activity balancing process as well as the reconciliation of subsidiary ledgers with the general ledger. The independent accountant should test whether reconciling differences are appropriately investigated and resolved in a timely manner and whether the reconciliations are reviewed and approved by appropriate supervisory personnel.
- Testing the accuracy and performing a review of delinquency reports to determine whether the institution initiates follow-up procedures on delinquent loans in accordance with its policies and whether the system identifies potentially troubled loans for purposes of assessing impairment.
- Checking the accuracy and performing a review of concentration reports (such as loans to one borrower, in a particular region, or in a specific industry) and related party loan reports.
- Reviewing internal audit, loan review, and examination reports to identify control weaknesses and exceptions.

- Observing or otherwise obtaining evidence that a proper segregation of duties exists among those who approve, disburse, record, and reconcile loans.
- Performing detailed tests of initial recording of loans, application of cash receipts, and changes in loan details (such as adjustment of rates for ARMs).

6.100 As discussed in chapter 3, the independent accountant should consider the guidance in SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324).

Substantive Tests

6.101 The independent accountant should determine the nature, timing, and extent of substantive tests based on an assessment of both inherent risk and control risk. Substantive tests that the independent accountant should consider follow.

6.102 ***Analytical Procedures.*** SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), provides guidance on the use of analytical procedures. In performing these procedures, the independent accountant should be careful not to review trends entirely from a historical perspective; current environmental and business factors, as well as local, regional, and national trends, should be considered in determining whether the institution's trends appear reasonable. Analytical procedures that the independent accountant may apply in the loan area include the analysis and evaluation of the following:

- Changes in the mix between different types of loans in the portfolio
- Comparison of aging of past-due loans with similar aging of prior year
- Comparison of loan origination volume by month with that of prior periods
- Current-year income compared with expectations and prior-year income
- Average loan balances by type in the current year compared with those of the prior year
- Comparison of yields on loans to the institution's established lending rates or pricing policies
- Reasonableness of balance-sheet accruals based upon underlying terms and amounts of corresponding loans
- Average yield throughout the period computed for each loan category on a monthly or quarterly basis

6.103 In using analytical procedures as a substantive test, the independent accountant should consider the implications of changes in important relationships and the extent of the difference between actual and expected results that can be accepted without further investigation. It is normally difficult to develop expectations to be used in analyzing yields on aggregated loans as a substantive test of related income amounts. Accordingly, analytical procedures in this area should generally be considered only as a supplement to other substantive procedures, except where an expected yield can be known with some precision.

6.104 ***Subsidiary Records.*** The independent accountant should generally obtain detailed schedules of loan principal balances and related accounts (accrued interest receivable, unearned discount, net deferred loan fees and costs, and so on) and reconcile ending balances with the trial balance, general ledger, and subsidiary records. The independent accountant should test significant reconciling items.

6.105 ***Confirmation.*** Guidance on the extent and timing of confirmation procedures is found in SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350), and SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312). Guidance on planning, performing, and evaluating samples is included in SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AICPA, *Professional Standards*, vol. 1, AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"). SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), discusses the relationship of confirmation procedures to the assessment of audit risk, the design of confirmation requests, the performance of alternative procedures, and the evaluation of confirmation results. SAS No. 67 stresses the importance of understanding the substance of transactions when determining information to include on confirmation requests. It sets forth criteria that must be met for the use of negative confirmations. SAS No. 67 also establishes a presumption that the independent accountant will request the confirmation of a financial institution's loans unless certain conditions are met.

6.106 ***Inspecting Loan Documents.*** Loan files vary considerably in content depending on the type of loan. Inspection of loan documents may provide evidence about the existence and ownership of the loan. If performing an inspection of loan documents, the independent accountant should be alert to notations or other indications of problems that merit further investigation or follow-up. When loan documents are in the possession of an attorney or other outside parties, the independent accountant should consider confirming the existence and ownership of such documents.

6.107 When inspecting loan documents, the independent accountant should consider testing the physical existence and reading any evidence of assignment to the institution of the collateral that supports collateralized loans. For certain loans, the independent accountant should consider inspecting collateral in the custody of the borrower, such as floor-plan merchandise. However, the independent accountant may conclude that a review of the reports of institution personnel who inspect collateral is sufficient audit evidence. The independent accountant should also consider examining or requesting confirmation of collateral not on hand. An inspection of loan documentation should include tests of the adequacy of both the current value of collateral in relation to the outstanding loan balance and, if needed, insurance coverage on the loan collateral.

6.108 While inspecting loan documents, the independent accountant should consider the audit objectives discussed in chapter 7. For example, for guaranteed loans, the independent accountant should read the financial statements and other evidence of the financial condition of cosignatories and guarantors and consider the institution's historical experience with enforcing guarantees.

6.109 While inspecting loan documents, the independent accountant should look for evidence of approvals by the board of directors or loan committee as required by management's written lending policies, evidence (such as stamped loan documents) that mortgage documents have been entered on the public record, a comparison of loan amounts with appraisals, and an inspection of whether hazard and title coverage meets coverage requirements set in management's written policy. For loans generated under certain governmental programs and other special arrangements, the independent accountant may be engaged to perform additional procedures required under the specific trust or servicing agreement.

6.110 ***Construction Loans.*** Audit procedures should be responsive to the institution's construction lending practices. The independent accountant should consider performing tests to determine whether construction loans are properly classified as loans rather than real estate investments. The independent accountant should consider testing origination, approval, inspection, and disbursements made based on progress on the particular construction project. The independent accountant should consider performing on-site inspections of significant construction projects to review the collateral and to determine whether construction has progressed in accordance with the loan terms.

6.111 ***Lease Financing.*** When confirming basic lease terms, the confirmation requests should include cancellation provisions, if any. Confirmation should ordinarily be requested from the lessee. For leveraged leases, material aspects of the lease agreement, including information required for income tax purposes, may be requested from the lease trustee. Although alternative methods may be used for reporting income for tax purposes, the independent accountant should determine that income for book purposes is being recorded in conformity with FASB Statement No. 13.

6.112 ***Whole Loans or Participations Purchased.*** Audit procedures for purchased loans should be similar to those for direct loans, except that requests for confirmation of balances, collateral, and recourse provisions, if any, are usually sent to the originating or servicing institution. Loan files for purchased participations should be available at the institution and should contain pertinent documents, or copies of them, including credit files supporting loans in which the institution has purchased participations from other banks or savings institutions. The independent accountant should consider confirming the actual status of borrower payments with the servicer. Although it is usually not practicable to confirm balances of serviced loans with the individual borrowers, the servicer's independent accountants often perform audit procedures on individual loans, such as confirmation with borrowers and examination of loan documents. SAS No. 70 provides guidance to independent accountants of a service organization on issuing a report on certain aspects of the service organization's internal control structure that can be used by other independent accountants and provides guidance on how other independent accountants should use such reports. The independent accountant should obtain copies of any reports issued under SAS No. 70 by the servicer's independent accountants when planning the extent of test work necessary in the loan area. Depending on the nature and type of the report, audit procedures performed at the servicer's site may be necessary. In some cases, the independent accountant may wish to request certain information, such as the scope and findings of the audit procedures performed by the servicer's independent accountants, directly from the servicer's independent accountant. The independent accountant should also consider reviewing the institution's files on the servicer to observe the general reliability of the servicer. The latest remittance report from the servicer should be reconciled with the records of the institution.

6.113 ***Accrued Interest Receivable and Interest Income.*** Interest income may be tested using computer-assisted audit techniques, recomputation of accrued amounts for individual accounts, analytical procedures, or some combination thereof. If interest rates were relatively stable during a period, interest income can often be tested effectively by using analytical tests by type of loan. The independent accountant should consider average balances in principal accounts, related yields as compared to averages of rates offered and of rates on existing loans, and other factors and relationships. As discussed in paragraph 6.102, the effectiveness of such analytical procedures may vary.

6.114 ***Balance-Sheet Classification of Loans.*** The independent accountant should consider whether any portion of loans is being held for sale and, therefore, whether a corresponding valuation allowance or write-down to lower of cost or market value is necessary. Previous loan sale activity, types of loans sold, transactions subsequent to year-end, pending contracts, and management's intentions are factors that should be considered in identifying loans held for sale.

6.115 ***Loan Fees and Costs.*** The independent accountant should review and test the propriety of the institution's deferral of loan origination fees and costs in accordance with FASB Statement No. 91. The independent accountant should also test the accretion of net deferred loan fees or costs.

6.116 ***Undisbursed Portion of Mortgage Loans.*** Banks and savings institutions sometimes record loans at the gross amount with an offsetting account entitled loans in process (LIP). As funds are disbursed, the LIP account is charged. Interest or fees on construction loans also may be debited to this account. The LIP account should be cleared when the loan is fully disbursed. LIP detailed ledgers should be reviewed to determine the propriety of accounting, including that for complex interest calculations. Unusual LIP balances, such as debit balances or balances outstanding for an excessive period of time (for example, over a year), may be indicative of problem loans.

6.117 A review of the LIP detailed activity may be done in connection with the examination of the current-year loan files. Loans selected for testing may be traced to the LIP account. Construction loans selected for testing may be traced to the LIP ledger, and disbursements may be reviewed in connection with the percentage of completion noted on inspection reports. In addition, if loan fees or interest are being capitalized (added to the loan balance) during construction, a review of the LIP ledgers may point out areas of concern. The independent accountant should consider whether to send confirmations to the borrower on any undisbursed loan balances.

6.118 ***Troubled Debt Restructurings.*** The independent accountant should perform procedures to identify TDRs and evaluate whether they have been accounted for in conformity with FASB Statements No. 15 and No. 114. Such tests should include procedures to determine whether possession of collateral has been taken without formal foreclosure proceedings (as discussed in paragraph 34 of FASB Statement No. 15, as amended).

6.119 ***Fair Value Disclosures.*** For loans for which there is a market price, the independent accountant may test fair value disclosures by reference to third-party market quotations, including information received from brokers or dealers in loans. Fair value estimates of loans for which there is no market price are highly subjective. There are a variety of methodologies that may be used by institutions to estimate fair values of loans. Most derive a fair value by discounting expected cash flows using appropriate interest rates. Some methodologies are relatively simple, such as methods that derive much of their data from the information used in estimating the allowance for credit losses, and some are relatively complex, such as option pricing models. As with all accounting estimates, the independent accountant's objective is to obtain sufficient competent evidential matter to provide reasonable assurance that the fair value estimates are reasonable in the circumstances and that they are presented in accordance with generally accepted accounting principles, including proper disclosure. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides relevant guidance. The independent accountant may decide to use the work of a specialist in assessing the entity's fair value estimates. SAS No. 73, *Using the Work of a Specialist,* provides guidance on using the work of a specialist. As described in paragraphs 3.28 through 3.33, the guidance of SAS No. 73 applies when an independent accountant uses a specialist's work as evidential matter in performing substantive tests to evaluate material financial statement assertions.

Chapter 7
Credit Losses

Introduction

7.01 Banks and savings institutions accept and manage significant amounts of credit risk. Loans or underlying collateral have traditionally been the source of most credit losses incurred by banks and savings institutions. The allowance for loan losses is an accounting estimate of credit losses inherent in an institution's loan portfolio that have been incurred as of the balance-sheet date.

7.02 Institutions may also have off-balance-sheet financial instruments, such as commitments to extend credit, guarantees, and standby letters of credit, that are subject to credit risk. Though liabilities related to credit losses associated with such off-balance-sheet instruments are not part of the allowance for loan losses, institutions' evaluation and estimate of the credit losses may include consideration of credit risk associated with those off-balance-sheet instruments, especially when the counterparty to an off-balance-sheet instrument is also a borrower. The information and guidance in this chapter, while generally referring to *loan* losses, may equally be useful in evaluating and estimating credit losses for off-balance-sheet instruments.

7.03 Chapter 6 discusses the various kinds of loans institutions make or purchase, the lending process and related internal controls, financial reporting for loans, and audit procedures for loans. However, because of the significance to an institution's financial statements of the allowance and the provision for loan losses and any separate liability for other credit losses, the high degree of subjectivity involved in estimating these amounts, the high degree of regulatory guidance and oversight directed toward institutions' estimates of credit losses, and, consequently, the relatively high inherent audit risk associated with auditing such estimates, careful planning and execution of audit procedures is essential in this area.

Management's Methodology

7.04 Management is responsible for estimating credit losses. Estimating that amount is unavoidably subjective, and, accordingly, management must make careful judgments about collectibility and estimates of losses. Management's judgments should include consideration of micro- and macro-economic factors; past, current, and anticipated events based on facts in evidence at the balance-sheet date; and realistic courses of action it expects to take.

7.05 An institution's method of estimating credit losses is influenced by many factors, including the institution's size, organizational structure, business environment and strategy, management style, loan portfolio characteristics, loan administration procedures, and management information systems. While different institutions may use different methods, there are certain common elements that should be included in any methodology for it to be effective. The method should—

a. Include a detailed and regular analysis of the loan portfolio and off-balance-sheet instruments with credit risk.

b. Include procedures for timely identification of problem credits.

c. Be used consistently.

d. Consider all known relevant internal and external factors that may affect collectibility.

e. Consider all loans (whether on an individual or pool-of-loans basis) and other relevant credit exposure.

f. Consider the particular risks inherent in the different kinds of lending.

g. Consider current collateral values, where applicable.

h. Be performed by competent and well-trained personnel.

i. Be based on current and reliable data.

j. Be well documented, with clear explanations of the supporting analyses and rationale.

7.06 Methods that rely solely on mathematical calculations, such as a percentage of total loans based on historical experience or similar allowance percentages of peer institutions, generally fail to contain the essential elements, because they do not involve a detailed analysis of an institution's particular transactions or consider the current economic environment.

7.07 As discussed below, creditors have traditionally identified loans that are to be evaluated for collectibility by dividing the loan portfolio into different segments. Each segment should contain loans with similar characteristics, such as risk classification, past-due status, and type of loan.

7.08 A key element of most methodologies is a credit classification process. The classification process involves categorizing loans into risk categories. The categorization should be based on conditions that may affect the ability of borrowers to service their debt, such as current financial information, historical payment experience, credit documentation, public information, and current trends. Management's categorization might, alternatively, be based on the institution's classification system. Many institutions classify loans using a rating system that incorporates the regulatory classification system.[1] These definitions are as follows:

a. *Substandard.* Loans classified as substandard are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

b. *Doubtful.* Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

c. *Loss.* Loans classified as loss are considered uncollectible and of such little value that their continuance as bankable assets is not war-

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[1] See *Interagency Policy Statement on Review and Classification of Commercial Real Estate Loans*, June 10, 1993.

ranted. This classification does not mean that the loan has absolutely no recovery or salvage value but, rather, that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

7.09 Some loans are also identified for a special mention. Such a loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or of the institution's credit position at some future date. Special-mention loans are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

7.10 Examples of such potential weaknesses are—

- Poor lending practices that result in significant defects in the loan agreement, security agreement, guarantee agreement, or other documentation and the deteriorating condition of or lack of control over collateral. In other words, these are conditions that may jeopardize the institution's ability to enforce loan terms or that reduce the protection afforded by secondary repayment sources.
- Lack of information about the borrower or guarantors, including stale financial information or lack of current collateral valuations.
- Economic or market conditions that in the future may affect the borrower's ability to meet scheduled repayments. These may be evidenced by adverse profitability, liquidity, or leverage trends in the borrower's financial statements.

7.11 Institutions generally analyze large loans and loans not conducive to pool analysis on an individual basis. This analysis is often performed by an internal loan review department. The loan review focuses on determining whether individual loans are properly classified as to credit risk and were made in accordance with the institution's written lending policies and whether the borrower is likely to perform in accordance with its contractual terms and conditions. The review includes analysis of (*a*) loan performance since origination or the last renewal, (*b*) the current economic situation of a borrower or guarantor, and (*c*) appraisals of current fair values of collateral. Borrower and guarantor financial statements are generally reviewed as to financial resources, liquidity, future cash flows, and other financial information pertinent to the ability to repay the debt. Collateral is reviewed to determine whether it is under the institution's control, whether security interests have been perfected (which is a legal determination), and whether the value is greater than the amount owed. Loan file contents are normally reviewed for completeness and conformity with the institution's written policies for loan documentation.

7.12 Foreign loans require special consideration because of the transfer risk associated with cross-border lending. Certain foreign loans are required by the Interagency Country Exposure Risk Committee (ICERC) pursuant to the International Supervision Act of 1983 to have allocated transfer risk reserves (ATRRs). ATRRs are minimum specific reserves related to loans in particular countries. Such reserves are minimums, and institutions may determine that a higher allowance is necessary based on its assessment of the probable losses. Foreign loans that have not been designated for ATRRs should be analyzed in the same way as domestic loans.

Large Groups of Smaller-Balance Homogeneous Loans and Leases

7.13 Loans not evaluated individually are included in large groups. The focus of the pool approach is generally on the loss experience for the pool. Loss experience, which is usually determined by reviewing the historical loss (chargeoff) rate for each pool over a designated time period, is adjusted for changes in trends and conditions. Trends and conditions that the institution should consider in determining how historical loss rates should be adjusted include—

- Levels of and trends in delinquencies and impaired loans.
- Levels of and trends in recoveries of prior chargeoffs.
- Trends in volume and terms of loans.
- Effects of any changes in lending policies and procedures.
- Experience, ability, and depth of lending management and other relevant staff.
- National and local economic trends and conditions.
- Credit concentrations.

Estimating Overall Credit Losses

7.14 Institutions may use a method that results in a range of estimates for the allowance for individual loans and large groups of loans and must apply careful judgment regarding the risks as well as other relevant factors for each segment of loans to determine the amount to record. (However, the measure of impairment under Financial Accounting Standards Board [FASB] Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan,* is based on a single best estimate and not a range of estimates.) The institution's conclusions about the appropriate amount should be well documented.

7.15 Management often considers credit risk associated with certain off-balance-sheet financial instruments (such as commitments to extend credit, guarantees, and letters of credit) at the same time it considers credit risk associated with the loan portfolio. While it is generally practical to consider credit losses on loans and other financial instruments at the same time, allowances necessary for off-balance-sheet instruments should be reported separately as liabilities and not as part of the allowance for loan losses.

7.16 Management should consider its overall loan loss allowance and liability for other credit exposures to be adequate only if such amounts are considered adequate to cover estimated losses inherent in the loan portfolio and the portfolio of other financial instruments, respectively. An illustration of a worksheet for an allowance and liability calculation is shown in exhibit 7.1.

Exhibit 7.1

Worksheet for Estimating Credit Losses

		Estimated Credit Loss Amount[†]	
Category	*Recorded Investment*[*]	*High*	*Low*
	$	$	$
Allowance for Estimated Loan Losses			
I Individually evaluated for impairment:[§]			
Impairment identified[‡]			
No impairment identified		N/A	N/A
II Large groups of smaller-balance homogeneous loans collectively[||] evaluated for impairment:			
Credit card			
Residential mortgage			
Consumer			
Other			
III Other large groups of loans containing unidentified, impaired loans[x]			
IV Loans measured at fair value or at the lower of cost or fair value		N/A	N/A
Total allowance for estimated loan losses		$	$
Liability for Losses on Credit Instruments and Other Credit Exposures			
Futures, forward, swap and option contracts and other financial instruments with similar characteristics (such as interest rate caps or floors)			
Standby letters of credit			
Commitments			
Loans sold with recourse			
Other			
Total liability for credit instruments and other credit exposures		$	$

[*] The total of amounts in this column generally should correspond to the institution's total loan (and lease) portfolio.

[†] For purposes of this worksheet, the estimated credit loss amount may be a specific amount or a range of estimated amounts. However, the measure of impairment under FASB Statement No. 114 is based on a single best estimate and not a range of estimated amounts.

[§] This category includes loans evaluated for impairment in conformity with FASB Statement No. 114.

[‡] This subcategory includes loans for which it is probable that the creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement and, accordingly, for which impairment is measured in conformity with FASB Statement No. 114.

[||] This category comprises large groups of smaller-balance homogeneous loans and leases that are collectively evaluated for impairment.

[x] This category comprises large groups of all other loans and leases not addressed in categories I or II and not individually considered impaired but that, on a portfolio basis, are believed to have some inherent but unidentified impairment.

7.17 Loan evaluations by management (and by independent accountants to the extent they are performed as part of the engagement) should avoid the following:

- *Collateral myopia.* This is the failure to see beyond collateral values to a financial weakness in the borrower. Collateral values and liquidity often tend to decline in periods when they are most needed to protect against loan losses. For example, if an oversupply in the real estate market causes lower-than-projected occupancy rates (creating cash flow problems for the borrower), the protection afforded by the collateral is diminished. Similar scenarios can be drawn for oil and gas reserves when energy prices decline, for specialized equipment (for example, drilling rigs, mining equipment, farm equipment, steel mills, and construction equipment) during specific industry slowdowns, for farmland during periods of depressed agricultural commodity and livestock prices, and for accounts receivable of a failing company.
- *Inadequate collateral appraisals.* This is the failure to critically review appraisals to understand the methods employed, assumptions made, and limitations inherent in the appraisal process, including undue reliance on management appraisals. Appraisal methods and assumptions may be inappropriate in the current circumstances. Going concern values generally are dramatically different from liquidation values. For example, real estate appraisals made on the income approach are not usually appropriate for incomplete projects or in circumstances in which operating conditions have changed.
- *Outdated or unreliable financial information.* This is the reliance on old, incomplete, or inconsistent data to assess operating performance or financial capacity. Financial information should be current and complete, particularly for borrowers sensitive to cyclical fluctuations or who demonstrate significant growth or changes in operating philosophy and markets.
- *Excessive renewals or unrealistic terms.* This is the reliance on current or performing-as-agreed status when the transaction has been structured to obscure weaknesses. Excessive renewals, unrealistic terms, and interest capitalization may be indications of such a structure. The purpose of a loan and performance against the original agreement should be critically reviewed.
- *Personal bias.* This is the bias of a reviewer for or against industries, companies, individuals, and products. For example, the involvement of a public personality in a venture could influence a reviewer to place more credibility than appropriate on the success of the venture.
- *Overlooking self-dealing.* This concerns directors or large shareholders who improperly use their position to obtain excessive extensions of credit on an unsound basis. In this situation, management is often unduly influenced by persons in these positions since management serves at the pleasure of the board and shareholders.
- *Dependence on management representations.* This is undue reliance on management representations when there is no supporting evidence. For example, such representations as "the guarantee is not signed but it is still good" or "the future prospects for this troubled borrower are promising" should be critically reviewed.

Regulatory Matters

7.18 The agencies' December 21, 1993, *Interagency Policy Statement on the Allowance for Loan and Lease Losses* discusses (*a*) the nature and purpose of the allowance, (*b*) the related responsibilities of the board of directors and management and of the examiners, (*c*) loan review systems, and (*d*) international transfer risk matters. Included in the discussion of examiner responsibilities is an analytical tool for assessing the reasonableness of management's loss allowance methodology. The tool involves comparison of the reported loss allowance against the sum of specified percentages (based on industry averages) applied to certain loan classifications. Related regulatory guidance strongly cautions examiners against using the tool as a rule of thumb or as a substitute for a full and thorough analysis of the bank's loan portfolio, in part because such comparisons do not take into account the often significant differences between institutions, their portfolios, underwriting and collection practices, and credit-rating policies.

7.19 The determination of loan loss allowances is necessarily a highly subjective process. Accordingly, management's use of the specified percentages as the primary basis for establishing loss allowances ordinarily would be questionable. Independent accountants should be alert to the risk that management may, inappropriately, rely on the tool to establish the loss allowance for certain loans instead of applying the judgment necessary to determine or evaluate the adequacy of the loss allowance for those loans. In such circumstances, independent accountants should ask management to justify that loss allowances have been established in conformity with generally accepted accounting principles (GAAP) rather than in accordance with the specified percentages.

7.20 The Office of the Comptroller of the Currency (OCC) provides guidance in its Banking Circular 201, *Allowance for Loan and Lease Losses*, for regulatory financial reporting purposes. The circular states the OCC's policy that banks must maintain an allowance for loan and lease losses that is adequate to absorb all estimated inherent losses in the bank's loan and lease portfolio. The circular also discusses the responsibility of the bank's board of directors and management for (*a*) maintenance of an effective loan review system, (*b*) controls to identify, monitor, and address asset quality problems, and (*c*) documentation of the bank's process for determining the level of the allowance (including analysis of significant factors affecting the collectibility of the portfolio). Practitioners serving national banks should be familiar with the circular.[2]

7.21 Practitioners should also be familiar with the Federal Deposit Insurance Corporation's May 7, 1991, memorandum, *Allowance for Loan and Lease Losses*, which provides guidance to agency examiners on assessing the adequacy of loan loss allowances and discusses related accounting literature. The memorandum also helps examiners highlight differences between regulatory and institution allowance rationales.

7.22 As discussed in paragraph 7.74, independent accountants should be skeptical if differences exist between the amounts of loan loss allowances estimated by management for regulatory purposes and for reporting in conformity with GAAP and should be prepared to justify such differences based on the circumstances.

7.23 Other guidance was provided to examiners in the agencies' November 7, 1991, joint issuance, in which they clarified regulatory policy in the areas of real estate loan valuation and classification, emphasizing that it is not reg-

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[2] The OCC is revising the circular to incorporate the requirements of FASB Statement No. 114.

ulatory policy to value real estate loans on a liquidation basis but, rather, on the income-producing capacity of loan collateral over time. Other matters addressed include—

- General principles examiners follow in reviewing commercial real estate loan portfolios.
- Indicators of troubled real estate markets, projects, and related indebtedness.
- Factors examiners consider in their review of individual loans, including the use of appraisals in the determination of collateral value.
- Approaches to valuing real estate, especially in troubled markets.
- Classification guidelines followed by the agencies, including the treatment of guarantees.
- Factors considered in the evaluation of an institution's allowance for loan and lease losses.

7.24 Examiners are required to provide independent accountants with regulatory examination reports, which generally disclose classified loans and certain statistics regarding those classifications. When a regulatory examination is in process, the independent accountant should discuss the status and preliminary findings of the examination with institution management and the examiners. (Communications with regulators are discussed further in chapter 2.)

7.25 The agencies established a policy on loan documentation effective March 30, 1993, to encourage lending to small and medium-sized businesses. The policy allows certain banks and savings institutions to establish a portfolio of loans exempt from certain documentation requirements. Examiners may not criticize the credit quality of an exempt loan on the basis of documentation and may not classify the loan unless it is more than sixty days delinquent. The institution's management, however, is still required to fully evaluate the collectibility of exempt loans in determining the adequacy of loan loss allowances. (See paragraph 7.60.)

Accounting and Financial Reporting

7.26 FASB Statement No. 114, (as amended by FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*), and FASB Statement No. 5, *Accounting for Contingencies*, are the primary sources of guidance on accounting for the allowance for loan losses.

7.27 FASB Statement No. 5 is the primary guidance on the accounting and reporting of loss contingencies, including credit losses.[3] It requires that a creditor evaluate the collectibility of both contractual interest and principal of all receivables when assessing the need for a loss accrual. FASB Statement No. 5 requires that an estimated loss from a loss contingency should be accrued by a charge to income if both of the following conditions are met:

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[3] Other examples of loss contingencies (provided in paragraph 4 of FASB Statement No. 5) include—

- Collectibility of receivables other than loans.
- Guarantees of indebtedness of others.
- Obligations of commercial banks under standby letters of credit.
- Agreements to repurchase receivables (or to repurchase the related property) that have been sold.

a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

b. The amount of loss can be reasonably estimated.

7.28 FASB Statement No. 5 states that when a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset (whether related to contractual principal or interest) can range from remote to probable. *Probable* means the future event or events are likely to occur; however, the conditions for accrual are not intended to be so rigid that they require virtual certainty before a loss is accrued. The conditions may be considered in relation to individual loans or groups of loans. However, if the conditions are met, a loss should be recognized even though the particular loans that are uncollectible may not be identifiable, such as large groups of loans for which credit losses have been incurred but which have not been associated with specific loans.

7.29 In estimating the amount of losses to be recognized under FASB Statement No. 5, institutions focus on the adequacy of the allowance for loan losses at each reporting date. The allowance for loan losses should be adequate to cover probable credit losses related to specifically identified loans as well as probable credit losses inherent in the remainder of the loan portfolio that have been incurred as of the balance-sheet date. Credit losses related to off-balance-sheet instruments should also be accrued and reported separately as liabilities if the conditions of FASB Statement No. 5 are met. Provisions for loan and other credit losses should be charged to operating income sufficient to maintain the allowance for loan losses or liabilities related to off-balance-sheet credit losses at an adequate level—that is, management should address the adequacy of the allowance and the liabilities, not of the provision charged against income.

7.30 Actual credit losses for loans, which may be for all or part of a particular loan, should be deducted from the allowance and the related loan balance should be charged off in the period in which they are deemed uncollectible. Recoveries of loans previously charged off should be added to the allowance when received. Actual credit losses for off-balance-sheet financial instruments should be deducted from the liability for credit losses in the period in which they are deemed uncollectible.

7.31 FASB Statement No. 114 addresses the accounting by creditors for impairment of certain loans, uncollateralized as well as collateralized, except for (*a*) large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment, (*b*) loans that are measured at fair value or at the lower of cost or fair value, (*c*) leases (as defined in FASB Statement No. 13, *Accounting for Leases*), and (*d*) debt securities as defined in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, as amended by FASB Statements No. 114 and No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, establishes the accounting for troubled debt restructurings.

7.32 FASB Statement No. 114 requires that such impaired loans be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral-dependent.[4] Paragraph 20 of FASB Statement No. 114, as amended, requires disclosure of information about loans that meet the definition of an impaired loan in paragraph 8 of the Statement. Included are various disclosures about the recorded investment in the impaired loans, the creditor's income recognition policy, restructured loans, and the activity in the allowance for loan losses.

7.33 In addition to disclosures required by FASB Statements No. 5 and No. 114, a description of the accounting policies and methodology the institution used to estimate its allowance or liability and related provisions for loan or other credit losses normally should be included in the notes to the financial statements. Such a description should identify the factors that influenced management's judgment (for example, historical losses and existing economic conditions) and may also include discussion of risk elements relevant to particular categories of financial instruments.

Auditing

Objectives

7.34 The primary objectives of audit procedures for credit losses are to obtain reasonable assurance that—

a. The allowance for loan losses is adequate to cover the amount of probable credit losses inherent in the loan portfolio at the balance-sheet date.

b. Credit losses and other items charged or credited to the allowance for loan losses, such as loan chargeoffs and recoveries, have been included in the financial statements at appropriate amounts and are properly disclosed.

The independent accountant attempts to achieve those objectives by testing management's estimates of the allowance based on available and relevant information regarding loan collectibility. The independent accountant is not responsible for estimating the amount of the allowance or ascertaining the collectibility of each, or any, specific loan included in an institution's loan portfolio.

Planning

7.35 The nature, timing, and extent of tests that the independent accountant applies to achieve the audit objectives are based on, among other things, the independent accountant's assessment of inherent risk and control risk. Because of the significance of loans to depository institutions' balance sheets, and because the determination of the allowance for loan losses is based on subjective judgments, independent accountants should generally assess inherent risk related to the allowance for loan losses as high. Such assessment should influence engagement staffing, extent of supervision, overall scope and strategy, and degree of professional skepticism applied. Further, independent

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[4] Paragraph 12 of FASB Statement No. 114 permits a creditor to aggregate impaired loans that have common risk characteristics and use historical statistics, such as average recovery period and average amount recovered, along with a composite interest rate as a means of measuring those impaired loans.

accountants should be familiar with the applicable regulatory guidance, including guidance on the classification of credits, concentration of credits, foreign loans, and significant related parties.

7.36 The audit procedures performed in connection with the allowance for loan losses typically are time-consuming and are most efficient when initiated early in the fieldwork. Because of the subjective nature of the loan review process, experienced audit personnel, preferably with prior depository institution engagement experience and, if necessary, with knowledge of industries in which the institution's loans are concentrated, should closely supervise or perform this section of the engagement. The assigned audit staff should also understand the lending environment, including credit strategy, credit risk, and the lending policies, procedures, and control environment of the institution, and should be familiar with known related parties and related party transactions.

7.37 An important planning consideration is whether an institution's internal loan review and internal audit functions can provide assistance to the independent accountant and permit the independent accountant to increase audit efficiency. Discussions with internal loan review and internal audit staff can provide the independent accountant with information concerning loan customers, related party transactions, and account histories that may not be readily available elsewhere. Also, because the internal audit department is involved in evaluating accounting systems and control procedures (as discussed in chapter 6), it can provide the independent accountant with important system descriptions that are helpful in understanding the internal control structure. Chapter 3 discusses consideration of the internal audit function.

7.38 In determining the scope of audit procedures, the independent accountant should consider its assessment of internal control risk (as discussed in paragraph 7.39) and general factors such as—

- Composition of the loan portfolio.
- Identified potential problem loans, including loans classified by regulatory agencies.
- Trends in loan volume by major categories, especially categories experiencing rapid growth, and in delinquencies and restructured loans.
- Previous loss and recovery experience, including timeliness of chargeoffs.
- Concentrations of loans to individuals and their related interests, industries, and geographic regions.
- Size of individual credit exposures (few, large loans versus numerous, small loans).
- Degree of reliance placed on internal loan review and internal audit functions.
- Total amount of loans and problem loans, including delinquent loans, by officer.
- Lending, chargeoff, collection, and recovery policies and procedures.
- Local, national, and international economic and environmental conditions.
- Experience, competence, and depth of lending management and staff.
- Results of regulatory examinations.
- Related party lending.

Internal Control Structure Over Financial Reporting and Possible Tests of Controls[5]

7.39 An effective internal control structure related to making and collecting loans (see chapter 6) and to estimating the allowance for loan losses should reduce the likelihood of material misstatement of the allowance for loan losses. The independent accountant should obtain an understanding of how management developed the allowance for loan losses and an understanding of the institution's loan portfolio, lending process, loan accounting policies, market focus, trade area, and other relevant factors. Specific aspects of an effective internal control structure related to the allowance for loan losses should include the following:

- *Management communication of the need for proper reporting of the allowance.* The control environment strongly influences the effectiveness of the system of controls and affects the independent accountant's assessment of control risk. The control environment reflects the overall attitude, awareness, and action of the board of directors and management concerning the importance of control. The independent accountant should consider (*a*) the level of involvement and quality of leadership provided by the board of directors, audit committee, and senior management in evaluating the allowance, (*b*) the organizational structure, (*c*) the independence and effectiveness of the internal audit and internal loan review functions, (*d*) methods of assigning authority, (*e*) management control methods, (*f*) personnel policies and practices, and (*g*) external influences.
- *Accumulation of relevant, sufficient, and reliable data on which to base management's estimate of the allowance.* Management reports summarizing loan activity, renewals, and delinquencies are vital to the timely identification of problem loans. The institution's procedures and controls are important for identifying when loans should be placed on nonaccrual status, reserved for, or charged off. Most institutions have written policies covering nonaccrual status, the timing of chargeoffs, and transfers of loans to the special asset or workout department.
- *Independent loan review.* Loan reviews should be conducted by institution personnel who are independent of the underwriting, supervision, and collections functions. The specific lines of reporting depend on the complexity of the institution's organizational structure, but the loan reviewers should report to a high level of management that is independent from the lending process in the institution.
- *Adequate review and approval of the allowance estimates by the individuals specified in management's written policy.* This includes—

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[5] In December 1995, the Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards,* vol. 1, AU sec. 319). SAS No. 78 revises the definition and description of internal control contained in the SASs to recognize the definition and description contained in *Internal Control—Integrated Framework* published by the Committee of Sponsoring Organizations of the Treadway Commission. SAS No. 78 is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted.

In conjunction with SAS No. 78, the ASB issued Statement on Standards for Attestation Engagements (SSAE) No. 6, *Reporting on an Entity's Internal Control over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2* (AICPA, *Professional Standards*, vol. 1, AT sec. 400). SSAE No. 6 conforms the description of elements of an entity's internal control to the components of internal control contained in SAS No. 78 and the *Internal Control—Integrated Framework*. SSAE No. 6 is effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, with earlier application permitted.

- — Review of sources of relevant information.
- — Review of development of assumptions.
- — Review of reasonableness of assumptions and resulting estimates.
- — Consideration of the need to use the work of specialists (such as appraisers or construction specialists).
- — Consideration of changes in previously established methods to arrive at the allowance.

- *Comparison of prior estimates related to the allowance with subsequent results to assess the reliability of the process used to develop the allowance.*
- *Consideration by management of whether the allowance is consistent with the operational plans of the institution.*

Substantive Tests

7.40 In evaluating the reasonableness of the allowance for loan losses, the independent accountant would normally concentrate on key factors and assumptions that are—

a. Significant to the estimate of the amount of the allowance, such as—
   - Current local, national, and international economic conditions and trends, particularly as they have an impact on collateral values.
   - The effectiveness of the institution's internal control structure related to loans and the allowance for loan losses.
   - The amount of recoveries of loans previously charged off.
   - Composition of the loan portfolio and trends in volume and terms of loans, as well as trends in delinquent and nonaccrual loans.
   - Identified potential problem loans and large groups of problem loans, including delinquent and nonaccrual loans and loans classified according to regulatory guidelines.
   - Concentrations of loans to individuals or entities and their related interests, to industries, and in geographic regions.
   - Size of specific credit exposures (a few large loans versus numerous small loans).
   - Degree of reliance placed on the internal loan review and internal audit functions.
   - The effects of changes in lending policies and procedures, including those for underwriting, credit monitoring, collection, and chargeoffs.
   - Results of regulatory examinations.
   - Nature and extent of related party lending.

b. Sensitive to variations. Assumptions based on historical trends, such as the amount of late or partial payments in a particular period and the amount of chargeoffs, can have a significant effect on estimates of the allowance.

c. Deviations from historical patterns. Trends in loan volume by major categories, especially categories experiencing rapid growth, and in chargeoffs, recoveries, delinquencies, nonaccrual, and restructured loans should be analyzed and considered.

d. Subjective and susceptible to misstatement and bias, such as—
   - The risk classification and allowance allocation given to problem loans.

- Estimates of collateral values, and the related assumptions that drive the determination of such values, such as cash flow estimates, discount rates, and projected occupancy rates.
- Current economic or market conditions that in the future may affect a borrower's ability to meet scheduled repayments.
- Contingencies, such as a commitment for funding from a third party.

7.41 The independent accountant should normally consider the historical experience of the institution in evaluating the adequacy of the allowance, as well as the independent accountant's experience with the industry. Changes in facts, circumstances, or an institution's procedures may cause factors different from those considered in the past to become significant to the estimate of the allowance.

7.42 Further, the independent accountant should consider the total credit exposure of particular borrowers, including that related to standby letters of credit, guarantees, commitments to lend, and other off-balance-sheet exposures.

7.43 In performing substantive procedures, the independent accountant should consider the following approaches:

a. Review and test the process used by management to develop the allowance.

b. Develop an independent expectation of the allowance to corroborate the reasonableness of the allowance.

c. Review subsequent events and transactions occurring prior to completion of fieldwork.

7.44 In most situations, the audit strategy will include aspects of all three approaches, with an emphasis on reviewing and testing the reasonableness of management's estimate. The independent accountant assesses reasonableness by performing procedures to test the process used by management to estimate the allowance. The following are procedures the independent accountant should consider:

- Identify whether there are controls over the preparation of the estimate of the allowance for loan losses and over the related supporting data that may be useful in the evaluation of the adequacy of the allowance and test controls.
- Identify the sources of data and other factors that management used in forming the assumptions and, based on information gathered in other audit tests, consider whether such data and factors are relevant, reliable, and sufficient for determining the allowance.
- Consider whether there are additional key factors or alternative assumptions about the factors.
- Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.
- Analyze historical data used in developing the assumptions to assess whether the data are comparable and consistent with data of the period under audit, and consider whether such data are sufficiently reliable for determining the allowance.
- Compare current-year chargeoffs with prior-period estimated losses to determine the historical reliability of prior-period estimates.

- Consider whether changes in the business or industry may cause other factors to become significant to the assumptions.
- Review available documentation of the assumptions used in developing the allowance and inquire about any other plans, goals, and objectives of the institution, and consider their relationship to the assumptions.
- Test the calculations used by management to translate the assumptions and key factors into the estimate of the allowance for loan losses.
- Consider using the work of a specialist regarding certain assumptions.

7.45 The independent accountant should also identify loans that contain high credit risk or other significant exposures and concentrations. Sources of information the independent accountant should consider include—

- Recent regulatory examination reports.
- Various internally generated listings, such as watch list loans, past-due loans, loans on nonaccrual and restructured status, loans to insiders (including directors and officers), and overdrafts.
- Management reports of total loan amounts by borrower.
- Reports of historical loss experience by type of loan or risk rating.
- Review of loan files, which should identify whether they are lacking current financial data of borrowers and guarantors or current appraisals and may identify loans that are frequently rolled over.
- Loan-documentation and compliance exception reports.
- Loan committee minutes.
- Inquiries of management regarding the experience and degree of turnover of loan officers.
- Reports of the independent loan review function or internal audit.
- The institution's written lending policies, especially any recent policy changes.
- Reports containing loans with repayment terms structured such that collectibility problems and concerns may not be evident until payments come due, such as construction loans with interest included in the loan commitment amount.

7.46 These documents and other sources may identify—

a. Borrowers experiencing problems such as operating losses, marginal working capital, inadequate cash flow, or business interruptions.

b. Loans secured by collateral that is not readily marketable or that is susceptible to deterioration in realizable value.

c. Loans to borrowers in industries experiencing economic instability.

d. Loan-documentation and compliance exceptions.

7.47 It should be noted that, to the extent that such information is found in reports prepared by management and is to be relied on in substantive tests, the accuracy and completeness of such information should be evaluated by, for example, reviewing loan subsidiary ledgers and tracing delinquencies to the past-due reports.

7.48 SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), provides guidance concerning the independent accountant's decision to use the work of a specialist. To properly evaluate the collectibility of certain loans, the independent accountant may need information outside of his or her usual experience. For example, the independent accountant might encounter valuation problems that require special knowledge of types of collateral. Factors to be considered in selecting a specialist include professional recognition of the specialist's competence in his or her field, reputation among peers, and relationship with the client.

7.49 For example, the knowledge of a specialist could be useful for loans based on oil and gas reserves. The specialist might review engineering reports on current reserves and production reports if the wells are in production. If fluctuating market conditions exist, a specialist could answer additional inquiries concerning the current status of oil and gas properties. For example, a loan secured by drilling equipment might have only marginal collateral value in a period of declining petroleum prices, even though the loan was highly secured when it was made.

7.50 Loans to developing countries are another example of instances in which the independent accountant may require the assistance of a specialist to become familiar with the economic, political, and social factors affecting the country's debt repayment. Other sources of such information include International Monetary Fund publications, international economists, and reports provided to institutions by the ICERC.

7.51 Engaging an appraiser, especially for real estate and other subjectively valued collateral, is another example of using a specialist. The independent accountant should be familiar with the basic concepts involved in the appraisal process in order to evaluate the competency and qualifications of appraisers. The AICPA Audit and Accounting Guide *Guide for the Use of Real Estate Appraisal Information* specifically addresses the understanding of the real estate appraisal process and the independent accountant's use of real estate appraisal information.

7.52 If the independent accountant finds that the appraisal or valuation information is deficient, the independent accountant should request that management secure additional information. Also, the independent accountant might consider selecting and hiring the appraiser or consultant directly.

7.53 ***Testing of Source Documents.*** The independent accountant should perform tests to determine that the loans are categorized in accordance with the objectives established and classified in accordance with the institution's loan review system. Detailed testing should focus on documents that are relevant to the institution's methodology.

7.54 ***Large Groups of Loans.*** For loans that are pooled for purposes of determining the allowance for loan losses, the focus of testing is not on individual loan files, and the collectibility of individual loans is generally not tested directly. Rather, the independent accountant generally reviews and tests for compliance with the institution's chargeoff and nonaccrual policy and tests the completeness and accuracy of historical data and reports, such as delinquency reports, that are relied upon in estimating the allowance for such loans.

7.55 For example, loan categories represented by large volumes of relatively small loans with similar characteristics, such as residential real estate mortgages, consumer loans, and credit-card loans, are generally evaluated on an aggregate, or pool, basis. The independent accountant is generally more concerned with the effectiveness of and adherence to procedures related to valuing such loans than with a critical appraisal of each individual loan. Unless unusual circumstances exist, the testing or procedures and the review of delinquency status reports should permit the independent accountant to draw a conclusion about the adequacy of the allowance required for those loan categories. In evaluating the adequacy of the portion of the allowance attributable to those loans, use of historical annual chargeoff experience is not sufficient in itself but should be considered in light of consistent application of loan policies and current and anticipated economic conditions based on facts in evidence at the balance-sheet date.

7.56 ***Individual Loan Review.*** Although the independent accountant's primary responsibility when reviewing the allowance for loan losses is evaluation of its adequacy as a whole, practical considerations may dictate that the review be directed to the separate categories of loans that constitute the institution's portfolio. Because the risk and other inherent characteristics of primary loan categories vary, the nature and extent of the separate reviews also can be expected to vary.

7.57 Conversely, an evaluation of commercial loans generally requires a more detailed review, since the amount of an individual loan is generally large and the type of borrower, purpose of the loan, and the timing of cash flows may be dissimilar. More important, a relatively small number of potential losses can significantly affect the adequacy of the allowance. In these circumstances, the independent accountant often selects and reviews in detail a number of problem loans.

7.58 In addition to identified problem loans, the independent accountant typically selects other commercial loans to include in the detailed loan file review. The selection of these additional loans generally includes a stratum of large loan balances above specified limits, loans from other sources (such as related parties and industry concentrations), and some loans selected without regard to size or other specific criteria. The independent accountant should be concerned with the total credit exposure of the borrower, including standby letters of credit and other commitments to lend, rather than with individual loan balances. Based on the independent accountant's evaluations and tests, the number of loans reviewed might be limited when the internal loan review function is deemed adequate in identifying and classifying problem credits.

7.59 The extent of an individual loan review varies from loan to loan. For example, a loan that has been subjected to a recent management review, an effective internal review, and a recent regulatory review may be reviewed in less detail than a loan that has not had some or all of those reviews.

7.60 An institution's exempt portfolio could be material to its financial statements. The exemption of certain loans from examiner review and criticism pursuant to the March 30, 1993, regulatory policy (see paragraph 7.25) does not extend to the independent accountant's responsibility in financial statement audits or other engagements involving management assertions about the exempt loans. An independent accountant's assessment of management assertions about credit quality may depend on the availability of certain documentation, including adequate collateral appraisals or current and complete financial information about borrowers or guarantors. The March 1993 policy may affect the availability of such documentation. Independent accountants are cautioned against undue reliance on management representations when no supporting evidence exists.

7.61 For each loan selected for review, the independent accountant normally prepares a loan review worksheet or other memoranda documenting the procedures performed and summarizing the conclusions reached. Exhibit 7.2 is an example of a loan review form that could be used for a commercial loan. It can also be adapted to other types of loans. For loans reviewed previously, the independent accountant typically updates prior reviews for new information concerning the loan. In addition, the independent accountant usually reviews correspondence updating classified loans, workpapers prepared by the institution's internal loan review personnel, and any regulatory examiner reports (including those with information on shared national credits). Such data often provide additional information concerning the loan and how management considered the loan in determining the allowance for loan losses.

Exhibit 7.2

Sample Loan Review Form

Client ______
Audit Date ______
Borrower's Name ______
Nature of Business ______
Purpose of Loan ______

I. Borrower's Notes

Description	*Effective Interest Rate*	*Direct Loan or Participation*	*Line of Credit / Commitment Amount*	*Outstandings* *Principal*	*Interest*
				______	______
Total loans outstanding at preliminary			/ /	______	______
Total loans outstanding at year-end			/ /	______	______

Accrual basis (Y/N) ______

Repayment Schedule: ______

Indicate probable repayment schedule, if different from contractual schedule.

Approach used to estimate impairment (check one):

___ Present value of cash flows

___ Fair value of collateral

___ Market value of loan

Repayment Status: ______

	Principal	*Interest*
Amount past due	______	______
Last payment:		
Date	______	______
Amount	______	______

(continued)

II. Contingencies/Guarantees (e.g., letters of credit, participations sold with recourse)

Total at preliminary	______
Total at year-end	______

III. Related Loans

Obligor	*Relationship*	*Maturity Date*	*Commitment Amount*	*Outstandings*
		Total related loans		______

IV. Collateral Summary

Description	*Gross Value*	*Prior Liens*	*Value to Lender*	*Basis for and Date of Valuation (e.g., appraisal, market value quotes)*
	______	______	______	______
Total	______	______	______	______

V. Guarantors

VI. Loan Grade

Regulatory		*Institution's In-House*	
Classification	*Amount*	*Classification*	*Amount*
Special mention			
Substandard			
Doubtful			
Loss			
Unclassified			
Total	______		______

Is the loan impaired not defined in FASB Statement No. 114 (Y/N)? ______

VII. Financial Data

Auditors ______________________________

Type of opinion ____________ Last audit date ______________

	Interim		Fiscal Year	
	Current Year ____ months ended / /	*Prior Year ____ months ended / /*	*Current Year / /*	*Prior Year / /*
Current assets				
Current liabilities				
Working capital				
Total assets				
Total liabilities				
Net worth				
Net sales				
Net income				
Cash flow				

VIII. Loan Officer ______________________________

Comments

(Provide a narrative analysis prepared by [or through inquiry of] the loan officer of collectibility including estimated repayment dates, sources of repayment, adequacy of collateral to cover outstanding principal and interest, financial data on guarantors, and rationale for any estimated allowance allocation, chargeoff, or both.)

Institution's estimated specific allowance allocation, chargeoff, or both and management's supporting rationale:

IX. Independent Accountant's Summary ______________________

X. Conclusion (including the amount and basis for independent accountant's estimated loss exposure) ______________________

7.62 For many loans, the independent accountant should discuss the status and background of the loans reviewed with the responsible loan officer and the loan review officer. In addition to providing information about the loans, such discussions may provide the independent accountant with information about the loan officer's and loan review officer's attitudes and degree of awareness of the status of loans and internal controls.

7.63 In reviewing individual loans, the independent accountant should review the institution's analysis of the borrower's financial resources, liquidity and future cash flows, and other financial forecasts, particularly for unsecured loans for which repayment is dependent on the borrower's ability to generate funds from profitable operations. The independent accountant should consider measuring such financial data against the trends and norms, both historical and forecasted, for both the borrower being reviewed and the industry in which the borrower operates. It is preferable that the institution's analysis be supported by current audited financial statements, although financial statements that have been reviewed or compiled by the borrower's independent accountant or prepared internally by the borrower may be acceptable.

7.64 If the independent accountant deems the financial information inadequate, the independent accountant should discuss the situation with the appropriate official. The results of such discussion or the inability of the institution to obtain adequate financial information should be considered in evaluating the collectibility of the loan. If adequate financial information is not available for significant loans, the independent accountant should notify management that a scope limitation may result.

7.65 For loans secured by collateral, a careful evaluation and valuation of that collateral is often necessary. In such circumstances, the independent accountant should evaluate the security interest in the collateral to determine if it has been perfected by execution and recording of the appropriate legal documents. The independent accountant should also review the reasonableness of the institution's collateral valuation by referring to quoted market prices or other pertinent sources, such as a specialist's appraisals or engineering reports.

7.66 The independent accountant may test the existence of the collateral by physical observation, independent confirmation, or other appropriate procedures, especially when the institution is involved in loans secured by marketable securities or in asset-based lending, which may include loans secured by inventories, equipment, or receivables. For collateral in the form of marketable securities, the independent accountant may evaluate whether such securities are under the institution's control, either in its own vault or in a safekeeping account in the institution's name maintained with an independent, third-party custodian. In the latter case, the independent accountant may wish to evaluate the independent custodian's ability to perform under its obligation. The AICPA's *Report of the Special Task Force on Audits of Repurchase Securities Transactions* discusses additional considerations applicable to loans collateralized with marketable securities. For other types of collateral, there should be documentation that the institution has verified the existence of the collateral. In the absence of such documentation, the independent accountant should perform these or other collateral verification procedures, especially for significant loans for which collectibility is otherwise questionable.

7.67 For loans supported by personal guarantees, the independent accountant may perform a review solely of the borrower's ability to pay. However, if the review indicates the guarantor may be a source of repayment, the independent accountant should also review the financial statements and other pertinent information about the guarantor as if the guarantor were the borrower. It is also important to consider the extent of, as well as the institution's policies and practices for, pursuing guarantees and to evaluate, perhaps in consultation with an attorney, the enforceability and scope of the guarantee.

7.68 The substance of a guarantee depends on (*a*) the ability and willingness of the guarantor to perform under the guarantee, including a determination of whether the guarantor has other guarantees outstanding that might be pursued, (*b*) the practicality of enforcing the guarantee in the applicable jurisdiction, (*c*) the scope of the guarantee (that is, whether it covers all principal and interest or has a limit), and (*d*) a demonstrated intent by the institution to enforce the guarantee. Even if the guarantee is legally enforceable, the independent accountant should attempt to determine if there are business reasons that might preclude the institution from enforcing the guarantee. Those business reasons could include the length of time required to enforce a guarantee, whether it is normal business practice to enforce guarantees on similar transactions, or whether the institution must choose between pursuing the guarantee or the underlying collateral, instead of pursuing both.

7.69 ***Participation and Purchased Loans.*** Management should have the information necessary to authorize, monitor, and review participation loans and to estimate any related allowance for loan losses. The collectibility of participation loans (whether at the lead institution or at a participating institution) is normally evaluated in light of the entire amount of the loan, not just of the share held by the institution. Accordingly, the participating institution should supplement documentation by the lead institution with its own investigation and credit analysis. The participating institution should not rely on the lead institution to monitor the credit. Certain large participation arrangements are reviewed by regulators, who issue a shared national credit report detailing their classification and rationale to the lead and all participating institutions. The independent accountant's objectives in testing loans for a participating institution is the same as for other loans. For example, the repayment status, borrowers' financial statements, and appraisals should be considered.

7.70 The independent accountant usually confirms the existence and terms of significant participations (both purchased and sold) with the debtor and lead institution. In addition, the independent accountant normally reviews the related loan file documentation. For participations, the loan files should contain the same information as other loan files.

7.71 ***Chargeoffs and Recoveries.*** The independent accountant should test the propriety of chargeoffs and recoveries. Substantive detail testing in this area may be minimized if tests of controls and analytical procedures on chargeoffs and recoveries are performed.

7.72 ***Analytical Procedures.*** The independent accountant should perform overall analytical tests to supplement the detailed tests of the reasonableness of the allowance. These analytical tests may use statistics relating to the allowance as compared to related income statement accounts, net chargeoff rates, nonperforming loan levels and other loan categories, historical experience, and peer results. Various analytical techniques can be utilized to assist the independent accountant in determining the adequacy of the allowance.

7.73 ***Conclusions.*** At the conclusion of the testing, the independent accountant should consider whether management's estimate of the allowance for loan losses is reasonable in relation to the financial statements taken as a whole. Since no one estimate of the allowance can be considered accurate with certainty, the independent accountant may, based on the testing performed and understanding of the facts and circumstances, determine a range for the allowance considered reasonable. If the institution's estimate is outside that reasonable range, the independent accountant should treat the difference between the institution's estimate and the closest reasonable estimate as a likely error and aggregate it with other likely errors, which the independent accountant must consider before reporting on the financial statements taken as a whole.

7.74 Furthermore, during their examinations of banks and savings institutions, regulators focus a great deal of attention on the allowance for loan losses. Failure to maintain an adequate allowance is considered an unsafe or unsound practice. The allowance that regulators are looking for is conceptually the same as the allowance that would be reported under GAAP. Nevertheless, the allowance amounts determined to be adequate by management and the regulatory examiners may differ due to the subjectivity involved in estimating the amount of the allowance. The FASB's Emerging Issues Task Force (EITF) reached a consensus in Issue No. 85-44, *Differences between Loan Loss Allowances for GAAP and RAP*, that the amount of the allowance reported in an institution's financial statements may differ from the amount reported for regulatory purposes. However, the EITF warned that independent accountants should be particularly skeptical of such differences and must justify them based on the particular facts and circumstances.

Chapter 8

Mortgage Banking Activities and Loan Sales

Introduction

8.01 Mortgage banking activities consist primarily of the purchase or origination of mortgage loans for sale to secondary market investors and the subsequent servicing of those loans. Mortgage loans can be grouped together and sold outright or pooled and securitized with or without a credit enhancement such as the guarantee of a federal agency or government-sponsored enterprise (GSE). This chapter discusses mortgage banking, as well as other sales or securitizations of loans.

8.02 Access to the secondary mortgage market is an important source of liquidity for banks and savings institutions. Many institutions have deposit bases that are keyed to variable rates and, therefore, are particularly sensitive to interest-rate risk. A variable-rate deposit base cannot fund long-term, fixed-rate assets without creating significant loss exposure in rising interest-rate environments. Therefore, sales of mortgage loans and servicing rights in the secondary market—and the accompanying gains and losses and creation of income streams from servicing and other fees—are an important source of funds to many institutions. Access to the secondary market also provides opportunities to restructure existing long-term portfolios.

8.03 The primary participants in the secondary market for residential financing are GSEs such as Federal Home Loan Mortgage Corporation (Freddie Mac) and Federal National Mortgage Association (Fannie Mae) and federal agencies such as Government National Mortgage Association (Ginnie Mae) and the Department of Veterans' Affairs (VA). These entities participate in the secondary market as issuers, investors, or guarantors of asset-backed securities (ABSs) such as mortgage-backed securities (MBSs), real estate mortgage investment conduits (REMICs), and collateralized mortgage obligations (CMOs). (Chapter 5 describes ABS transactions and considerations for investors in ABSs.) Many private entities are also active in the secondary market as issuers and investors.

8.04 When mortgage loans are originated for sale, the process includes not only finding an investor but also preparing the loan documents to fit the investor's requirements. Mortgage loans originated for sale normally must comply with specific standards governing documentation, appraisal, mortgage insurance, loan terms, and borrower qualifications. Investors will typically review underlying documentation prior to completing their purchase. Individual loans that fail to meet the specified criteria are eliminated from the pool of loans eligible for sale. If exceptions cannot be corrected, the selling institution may have to either find alternative investors or transfer the loan to the institution's portfolio. In most cases, the originating institution may be subject to recourse by the investor for underwriting exceptions identified subsequent to the sale of the loans and any related defaults by borrowers.

8.05 The extent to which mortgage loans are originated for sale will differ for each institution. Factors such as liquidity, interest-rate exposure, asset/liability management policy, and capital considerations will influence the nature and extent of an institution's mortgage banking activities. One institution may manage its interest-rate risk position by intentionally selling all fixed-rate mortgage loans it originates, while another institution may originate a variety of both fixed- and variable-rate loan products for sale.

Loan Servicing

8.06 When mortgage or other loans are sold, the selling institution sometimes retains the right to service the loans for a servicing fee, normally expressed as a percentage of the principal balance of the outstanding loans, that is collected over the life of the loans as payments are received. A typical servicing agreement requires the servicer to carry out the servicing function, including billing and collection of borrowers' payments; remittance of payments to the investor, insurers, and taxing authorities; maintenance of custodial bank accounts; and related activities. The agreement also may involve significant risks being retained by the servicer such as allowing the investor recourse to collect certain credit losses from the servicer. Serviced loans may have been originated by the servicer institution itself or by other financial institutions.

Regulatory Matters

8.07 Loan sale transactions may receive different treatment under regulatory accounting practices. The Office of Thrift Supervision follows generally accepted accounting principles as established by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*. The other agencies generally require sales of assets with recourse to be accounted for as financings and permit banks to report such transfers as sales only when the transferor (*a*) retains no risk of loss from the assets transferred and (*b*) has no obligation for the payment of principal or interest on the assets transferred. However, this rule generally does not apply to transfers of one-to-four family or agricultural mortgage loans made under programs of Ginnie Mae, Federal Agricultural Mortgage Corporation (Farmer Mac), Fannie Mae, and Freddie Mac, which are generally treated as sales in regulatory financial reports.

8.08 The Federal Financial Institutions Examination Council (FFIEC) announced its interim decisions about regulatory reporting treatment of mortgage servicing rights in a June 21, 1995, press release.

Accounting and Financial Reporting[1]

Mortgage Loans and MBSs Held for Sale

8.09 FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities,* establishes the accounting for mortgage loans held for sale and the accounting for mortgage loan sales.

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[1] In October 1995, the FASB issued a proposed Statement, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The proposed Statement would significantly affect accounting for (including disclosures about) sales of partial interests, servicing assets and liabilities, securities lending transactions, repurchase agreements, "wash sales," loan syndications and participations, risk participations in banker's acceptances, factoring arrangements, and transfers of receivables with recourse.

The proposed Statement also addresses accounting for securitizations of loans, including mortgage loans not being held in conjunction with mortgage banking activities. In current practice, the securitization of loans not being held for sale is similar to a wash sale and no gain or loss is recognized on securitization. After securitization, the securities are accounted for according to the provisions of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

Comments on the proposed Statement were due in January 1996. Readers should be alert to any final pronouncement.

8.10 Paragraph 4 of FASB Statement No. 65 requires that MBSs held for sale in conjunction with mortgage banking activities should be classified as trading securities and reported at fair value in conformity with FASB Statement No. 115. Paragraph 4 of FASB Statement No. 65 says that mortgage loans held for sale should be reported at the lower of cost or market value, determined as of the balance-sheet date. Paragraph 4 requires that changes in the valuation allowance should be included in the determination of net income of the period in which the change occurs. Paragraph 4 requires that the amount by which the cost of such loans exceeds their market value should be accounted for as a valuation allowance.

8.11 Paragraph 6 of FASB Statement No. 65, as amended by FASB Statement No. 115, requires that the securitization of a mortgage loan held for sale be accounted for as the sale of the mortgage loan and the purchase of an MBS classified as a trading security at fair value. Paragraph 6 requires that mortgage loans transferred from loans held for sale to long-term-investment classification should be valued at the lower of cost or market on the transfer.

8.12 Paragraph 9 of FASB Statement No. 65 says that either the aggregate or individual loan basis may be used in determining the lower of cost or market value for each type of mortgage loan. Paragraph 9 of FASB Statement No. 65, as amended by FASB Statement No. 115, states that the market value of committed mortgage loans and uncommitted mortgage loans should be determined separately as follows:

a. Committed loans should be valued based on actual commitment prices. The contractual service fee should be valued in accordance with FASB Statement No. 65.

b. Uncommitted loans should be valued based on the market in which the institution normally operates:

(1) Commitment prices, to the extent the commitments clearly represent market conditions at the balance-sheet date

(2) Market prices and yields sought by the mortgage banking enterprise's normal market outlets

(3) Quoted Ginnie Mae security prices or other public market quotations for long-term mortgage loan rates

(4) Freddie Mac and Fannie Mae current delivery prices

8.13 Paragraph 12 of FASB Statement No. 65 requires, in part, that the carrying amount of mortgage loans to be sold to an affiliated enterprise (as defined) should be adjusted to the lower of cost or market value of the loans as of the date management decides that a sale to an affiliated enterprise will occur. Paragraph 13 of the Statement requires, in part, that, if a particular class of mortgage loans or all loans are originated exclusively for an affiliated enterprise, the originator is acting as an agent of the affiliated enterprise, and the loan transfers should be accounted for at the originator's acquisition cost.

Sales of Loans

8.14 The objectives of accounting for sales of loans are to recognize the economic gain or loss from the transaction in the period of sale and to avoid recognition in that period of income or expenses attributable to future periods. Consequently, when loans are sold outright and are not to be serviced by the selling institution (sold with servicing released), the gain or loss is measured by calculating the difference between the selling price and the carrying amount of the loans sold (including applicable deferred loan fees and costs, premiums and discounts, and related allowances, if any).

8.15 Variable-rate loans are generally sold at stated rates, with gain or loss measurement based on a premium or discount on the face value of the portfolio to be sold. Fixed-rate loans are generally sold at a discount or premium to provide a specified yield to the investor, and the corresponding gain or loss is based on the difference between the yield of the loans to be sold and the contractual yield to the investor. The yield on a pool of loans is the calculated weighted-average interest rate for that pool.

8.16 If mortgage loans are sold with servicing retained, and the servicing fee rate differs materially from a normal servicing fee rate (see paragraph 11 of FASB Statement No. 65 and FASB Technical Bulletin No. 87-3, *Accounting for Mortgage Servicing Fees and Rights*, as amended by FASB Statement No. 122, *Accounting for Mortgage Servicing Rights*) the sales price should be adjusted, for purposes of determining gain or loss on the sale, to provide for the recognition of a normal servicing fee in each subsequent year. The amount of the adjustment is the difference between the actual sales price and the estimated sales price that would have been obtained if a normal servicing fee rate had been specified.[2]

8.17 The FASB's EITF has also reached consensuses on a variety of mortgage banking issues, including accounting for sales of participations and implications of prepayments on the valuation of excess servicing fee receivables. Because of the complexity and variety of issues associated with loan sale transactions, current FASB pronouncements should be consulted when an institution's financial statements include loan sale transactions.

8.18 Once a decision has been made to sell loans, they should be carried at the lower of cost or market value. Gains, however, should not be recognized before the closing of the sale, that is, when title has passed and, other than the recourse obligations described in paragraph 8.20, there are no significant unresolved contingencies. (FASB Statement No. 115 addresses accounting for securities, including pools of loans that have been securitized.)

8.19 In Issue No. 88-11, the FASB's EITF discussed how, when a portion of a loan is sold, the institution's recorded investment in the loan should be allocated between the portion of the loan sold (for purposes of determining the gain or loss on the sale) and the portion retained (for purposes of determining the remaining recorded investment). That loan may be any type of receivable

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[2] The FASB's Emerging Issues Task Force (EITF) reached a consensus in Issue No. 88-11, *Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold*, that, under footnote 4 to paragraph 11 of FASB Statement No. 65, the difference between the normal and stated servicing fees, if any, over the estimated life of the loan should be calculated using prepayment, default, and interest-rate assumptions that market participants would use for similar financial instruments and should be discounted using an interest rate that a purchaser unrelated to the seller of such a financial instrument would demand. Therefore, the discount rate should be comparable to the rate on similar financial instruments (for example, interest-only securities [IOs]) and should reflect the risks associated with the asset. Prepayments of the underlying loans directly affect the asset or liability valuation and should be evaluated routinely to ensure that amortization appropriately reflects prepayment experience. EITF Issue No. 86-38, *Implications of Mortgage Prepayments on Amortization of Servicing Rights*, addresses how unanticipated prepayments affect accounting for excess servicing fee receivables.

or debt security, including an MBS, a corporate bond, or a Treasury bill, note, or bond.

Sales of Loans With Recourse

8.20 Institutions may sell loans with recourse. This may be done to deliver loans into a particular investor's commitment program, to obtain a better price, or both. Because of the continuing risk of delinquency and foreclosure, the institution's management should carefully evaluate its potential contingent liabilities with respect to such loans. FASB Statement No. 77 provides guidance on accounting for sales of loans with recourse. EITF Issue No. 92-2, *Measuring Loss Accruals by Transferors for Transfers of Receivables with Recourse*, states that obligations recorded by a transferor under the recourse provisions relating to the transfer of a receivable should include all probable credit losses over the life of the receivable transferred, and not only those measured and recognized under FASB Statement No. 5, *Accounting for Contingencies*, prior to the transfer.

Servicing Rights

8.21 Servicing rights are significant assets for some institutions. They have value in addition to the servicing fee value because of the servicer's ability to invest the "float" that results from payments that are received from borrowers but are not yet passed on to the investors in the loans. Additionally, intrinsic value components of servicing rights include ancillary income, such as late-payment charges and prepayment charges. Accordingly, servicing rights, either separately or as part of a loan, are generally readily purchased and sold.

8.22 Paragraph 16 of FASB Statement No. 65, as amended by FASB Statement No. 122, requires that mortgage banking enterprises (as defined) recognize as separate assets rights to service mortgage loans for others, however those servicing rights are acquired.[3] A mortgage banking enterprise that acquires mortgage servicing rights through either the purchase or origination of mortgage loans and sells or securitizes those loans with servicing rights retained should allocate the total cost of the mortgage loans to the mortgage servicing rights and the loans (without the mortgage servicing rights) based on their relative fair values if it is practicable to estimate those fair values. If it is not practicable to estimate the fair values of the mortgage servicing rights and the mortgage loans (without the mortgage servicing rights), the entire cost of purchasing or originating the loans should be allocated to the mortgage loans (without the mortgage servicing rights) and no cost should be allocated to the mortgage servicing rights.

8.23 Paragraph 17 of FASB Statement No. 65, as amended, requires that a mortgage banking enterprise assess its capitalized mortgage servicing rights for impairment based on the fair value of those rights. Paragraph 17 further requires that a mortgage banking enterprise should stratify its mortgage serv-

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[3] FASB Statement No. 122 applies prospectively in fiscal years beginning after December 15, 1995, to transactions in which a mortgage banking enterprise sells or securitizes mortgage loans with servicing rights retained and to impairment evaluations of amounts capitalized as mortgage servicing rights, including those purchased before the adoption of the Statement. Retroactive capitalization of mortgage servicing rights retained in transactions in which a mortgage banking enterprise originates mortgage loans and sells or securitizes those loans before the adoption of the Statement is prohibited.

icing rights that are capitalized after adoption of FASB Statement No. 122 based on one or more of the predominant risk characteristics of the underlying loans. Paragraph 17 requires that the amount of impairment recognized should be the amount by which the capitalized mortgage servicing rights for a stratum exceed their fair value. Paragraph 17 also requires that impairment should be recognized through a valuation allowance for each impaired stratum.

8.24 ***Sales of Servicing Rights.***[4] Sales of servicing rights relating to loans previously sold may be recognized in income subject to the considerations discussed below. Sales of servicing rights relating to loans that are retained should not be recognized in income at the time of sale. The proceeds from such sales should be accounted for in a manner similar to loan discounts and amortized using the interest method as an adjustment to the yield of the related loans.

8.25 In general, three to six months elapse between entry into a contract to sell servicing rights and actual delivery of the loan portfolio to be serviced. These delays may result from the purchaser's inability to accept immediate delivery, the seller's inability to immediately transfer the servicing records and loan files, difficulties in obtaining necessary investor approval, requirements to give advance notification to mortgagors, or other planning considerations. Issues relating to the transfer of risks and rewards between buyers and sellers of servicing rights may be complex.

8.26 EITF Issue No. 95-5, *Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights*, addresses whether certain provisions of agreements to sell mortgage servicing rights preclude the recognition of a sale at the date title passes, or whether the sale should be recognized at that date with accrual of any estimated liability. In Issue No. 95-5, the EITF reached a consensus that

> sales of rights to service mortgage loans should be recognized when the following conditions have been met (1) title has passed, (2) substantially all risks and rewards of ownership have irrevocably passed to the buyer and (3) any protection provisions retained by the seller are minor and can be reasonably estimated. If a sale is recognized and minor protection provisions exist, a liability should be accrued for the estimated obligation associated with those provisions. The seller retains only minor protection provisions if (a) the obligation associated with those provisions is estimated to be no more than 10 percent of the sales price and (b) risk of prepayment is retained for no longer than 120 days.

8.27 The EITF carried forward from Issue No. 89-5 the consensus that

> a temporary subservicing agreement in which the subservicing will be performed by the seller for a short period of time would not necessarily preclude recognizing a sale at the closing date.[5]

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[4] In October 1995, the FASB issued a proposed Statement, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The proposed Statement would, among other things, significantly affect accounting for (including disclosures about) servicing assets and liabilities. Comments on the proposed Statement were due in January 1996. Readers should be alert to any final pronouncement.

[5] Issue No. 95-5 also says that the consensus carried forward from Issue No. 89-5 supersedes the consensuses reached by the EITF in Issue No. 89-5.

8.28 Criteria that should be considered when evaluating whether a sale of mortgage servicing rights has occurred should include—

- Whether the seller has received written approval from the investor if required.[6]
- Whether the buyer is a currently approved seller/servicer and is not at risk of losing approved status.
- In the event of a sale in which the seller finances a portion of the sales price, whether an adequate nonrefundable down payment has been received (necessary to demonstrate the buyer's commitment to pay the remaining sales price) and whether the note receivable from the buyer provides full recourse to the buyer. Nonrecourse notes or notes with limited recourse (such as to the servicing) are not acceptable.

8.29 Also, temporary servicing performed by the seller for a short period of time should be compensated in accordance with a subservicing agreement that provides a normal subservicing fee. Any benefits related to escrow deposits held by the seller during the temporary servicing period generally accrue to the buyer.

8.30 EITF Issue No. 85-13, *Sales of Mortgage Service Rights on Mortgages Owned by Others*, addresses whether (and how) gains should be recorded on such sales.

8.31 EITF Issues No. 87-34, *Sale of Mortgage Servicing Rights with a Subservicing Agreement*, and No. 90-21, *Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement*, provide additional guidance.

VA No-Bids and Private Mortgage Agencies

8.32 Historically, the VA paid lenders 100 percent of the outstanding debt on defaulted loans that the VA guaranteed. In return, the lenders turned the borrowers' houses over to the VA, which would dispose of them. The VA has the option of guaranteeing the lesser of 60 percent of a loan's original balance or $27,500, leaving the property with the lender if that is less costly for the agency. Called a *no-bid option*, this practice was seldom used, especially since inflation pushed up housing prices during the late 1970s and early 1980s. However, as inflation began to slow and the costs of carrying foreclosed houses began to rise, the VA began to invoke the no-bid option. The amount of no-bid activity has increased sharply in the last few years. Particularly hard hit have been mortgage lenders in economically depressed areas, such as energy-producing and agricultural regions of the United States. Institutions may incur losses due to the uncollectibility of receivables from other government programs such as the Federal Housing Administration (FHA) or Ginnie Mae, from other investors such as Freddie Mac and Fannie Mae, or from insolvent private mortgage insurers.

8.33 With the increased risk of foreclosure losses (including unrecoverable interest advances; foreclosure costs such as attorneys' fees, inspections,

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[6] Servicing rights may be purchased by brokers or investment bankers that intend to seek buyers for the rights. Although such purchases cannot be canceled, approval of transfer of the rights is not requested by the seller until the broker enters into a transaction with the third-party purchaser. Thus, such transactions should generally be characterized as financing transactions and a sale has not occurred until an approval of transfer of rights has been requested, even though other contingencies are resolved.

and so forth; and the implicit cost to carry the asset until ultimate sale), the evaluation of loss allowances on VA and privately insured mortgage loans has become increasingly difficult. Chapter 9 provides guidance on the valuation of foreclosed real estate, and chapter 7 provides guidance on the evaluation of the collectibility of real estate loans.

Financial Statement Presentation and Disclosure

8.34 Loans held for sale should be presented separately on the face of the balance sheet and should be reported at the lower of cost or market value. MBSs held for sale in conjunction with mortgage banking activities should be classified as trading securities and reported at fair value in conformity with FASB Statement No. 115. The amount of aggregate gains or losses on sales of loans (including adjustments to record loans held for sale at the lower of cost or market value) should be presented separately on the face of the income statement. Net cash flows from purchases, originations, and sales of loans held for sale should be classified as operating cash flows. Net cash flows from sales of other loans should be classified as investing cash flows.

8.35 Paragraph 29 of FASB Statement No. 65 requires that the financial statements should disclose the method used in determining the lower of cost or market value of mortgage loans (that is, aggregate or individual loan basis).

8.36 Paragraph 30 and following of FASB Statement No.65, as amended by FASB Statement No. 122, require disclosure of:

a. The amount capitalized during the period in connection with acquiring the right to service mortgage loans.

b. The method of amortizing the capitalized amount.

c. The amount of amortization for the period.

d The fair value of capitalized mortgage servicing rights and the methods and significant assumptions used to estimate that fair value.[7]

e. The risk characteristics of the underlying loans used to stratify capitalized mortgage servicing rights for purposes of measuring impairment.

f. For each period for which results of operations are presented, the activity in the valuation allowances for capitalized mortgage servicing rights, including—

(1) the aggregate balance of the allowances at the beginning and end of each period

(2) aggregate additions charged and reductions credited to operations

(3) aggregate direct write-downs charged against the allowances

[7] The paragraph also states "If no cost is allocated to certain mortgage servicing rights in accordance with the last sentence of paragraph 16 [of FASB Statement No. 65], the mortgage banking enterprise shall describe those mortgage servicing rights and shall disclose the reasons why it is not practicable to estimate the fair values of the mortgage servicing rights and the mortgage loans (without the mortgage servicing rights)."

Auditing

Objectives

8.37 Audit objectives and procedures for loan origination and underwriting are discussed in chapter 6. Audit objectives and procedures for securities, including MBSs, are addressed in chapter 5. The primary audit objectives in this area are to obtain reasonable assurance that—

a. Loans held for sale exist and are the property of the institution.

b. Loans held for sale are valued at the lower of cost or market value.

c. Loans held for sale are properly classified, described, and disclosed in the financial statements.

d. Escrow advances are properly recorded and collectibility is reasonably assured.

e. Gains and losses on the sale of loans or servicing rights are properly measured, recorded, and disclosed.

f. Excess servicing receivables, deferred loan sale discounts, and purchased servicing rights are presented at recoverable amounts.

g. Proper title has passed to the holder of purchased servicing rights.

h. Loss contingencies associated with servicing responsibilities, sales with recourse, or other factors are adequate.

Planning

8.38 In planning the audit, the independent accountant should obtain an understanding of mortgage banking activities in which the institution is engaged. The independent accountant should inquire about how the mortgage banking activities relate to management's objectives for managing interest-rate risk and enhancing liquidity. The independent accountant should inquire about the reporting systems used by management to account for mortgage banking activities and should consider whether management has sufficient data to evaluate loan sale transactions, identify loans held for sale, and track mortgage loan commitments and applications. Such information is usually needed to manage risks arising from mortgage banking activities.

8.39 Institutions acting as servicers of loans have a fiduciary responsibility to parties under the agreement. Failure to meet these responsibilities may result in contingent liabilities that could have a material effect on an institution's financial statements. Under contracts with third parties such as Ginnie Mae, Freddie Mac, Fannie Mae, and the Department of Housing and Urban Development (HUD), an institution must meet certain minimum net worth requirements. Failure to meet the requirements could result in termination of the servicing contract. In addition, the independent accountant should consider whether an institution's servicing systems ensure proper controls over investor and escrow accounts (for example, for taxes and insurance or loan principal and interest) and evaluate the potential for contingencies liabilities associated with noncompliance with investor-servicing requirements.

8.40 Contractual agreements with Ginnie Mae, Freddie Mac, Fannie Mae, HUD, or other investors may require engagements related to aspects of the contractual agreement.

Internal Control Structure Over Financial Reporting and Possible Tests of Controls[8]

8.41 The discussions of internal control structure policies and procedures in chapters 6 and 7 are also relevant to mortgage banking activities.

8.42 ***Policies and Procedures.*** Examples of typical internal control structure policies and procedures relating to financial reporting of mortgage banking activities include—

- Use of a quality control function to monitor underwriting and documentation practices.
- Executive management review of open and pending commitments to buy or sell and strategies to minimize exposure to changing interest rates.
- Loans sold with servicing retained are properly identified for derecognition.
- Periodic reconciliation of cash receipts and payments applied to the servicing (custodial) system.
- Periodic reconciliations of custodial accounts (the frequency of reconciliation should be determined by the level of account activity).
- Periodic reconciliation of servicing fees received to servicing fee income recorded in the general ledger.
- Periodic evaluation of the recoverability of excess servicing receivables purchased servicing values, and other capitalized costs.

8.43 After obtaining an understanding of internal control structure policies and procedures related to mortgage banking activities, the independent accountant may conclude that the policies and procedures that have been placed in operation are likely to be effective and that audit efficiency can be improved by assessing control risk at below the maximum. Tests of controls that may be used to obtain evidence to support such an assessment include—

- Selecting a sample of borrower remittances and testing allocation of payment amounts to income, principal, escrow, and service fee accounts (a procedure that also provides substantive evidence).
- Reviewing custodial account reconciliations and supporting documentation to ensure that all activity is processed and cleared currently.
- Selecting a sample of delinquent loans serviced and considering whether collection and follow-up procedures are performed on a timely basis and are in accordance with investor requirements.
- Examining loan documentation. (See chapter 6.)

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[8] In December 1995, the Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). SAS No. 78 revises the definition and description of internal control contained in the SASs to recognize the definition and description contained in *Internal Control—Integrated Framework* published by the Committee of Sponsoring Organizations of the Treadway Commission. SAS No. 78 is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted.

In conjunction with SAS No. 78, the ASB issued Statement on Standards for Attestation Engagements (SSAE) No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2* (AICPA, *Professional Standards*, vol. 1, AT sec. 400). SSAE No. 6 conforms the description of elements of an entity's internal control to the components of internal control contained in SAS No. 78 and the *Internal Control—Integrated Framework*. SSAE No. 6 is effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, with earlier application permitted.

Substantive Tests

8.44 The independent accountant should determine the nature, timing, and extent of substantive tests based on an assessment of both inherent risk and control risk. Substantive tests that the auditor should consider include[9]—

- Reviewing and testing the documentation supporting escrow and investor account reconciliations. Custodial accounts may be off-balance-sheet accounts. Accordingly, the independent accountant may need to select custodial accounts from records independent of the general ledger. In this case, the independent accountant may need to perform separate tests of the completeness and accuracy of custodial records.
- Evaluating the propriety of loan classifications to determine that all loans held for sale within the loan portfolio are properly identified. In evaluating whether loans are held for sale or in the loan portfolio, the independent accountant should consider management policy and practices (for example, previous loan sale activity, types of loans sold, transactions subsequent to year-end, and pending contracts) and whether management has the ability and intent to hold the loans for the foreseeable future or until maturity.
- Reviewing the documentation and recalculating the amounts supporting the measurement of lower of cost or market valuation for loans held for sale.
- Selecting a sample of loan sales made during the period and reviewing investor contracts to evaluate whether excess and normal servicing fees, sale-versus-financing treatment, and so on, have been treated properly.
- Recalculating a sample of loan sale transactions to test calculation of weighted-average rates and corresponding gains or losses and vouching payments received for those transactions.
- Analytically projecting service fees for comparison with service fee revenues reported in operating income for the period.
- Analyzing prepayment data used by management to calculate excess servicing receivables at sale date and the systems used to update prepayment data over time for actual prepayment experience, selecting a sample of loan pools sold in prior periods, and comparing the actual current loan balance with estimates.
- Evaluating the adequacy of valuation allowances for servicing and escrow advances. Some investors require that contractual interest and principal be remitted to them by the servicer regardless of mortgagor performance. Advances of such amounts are frequently made in anticipation of borrower performance and must be tracked on an individual basis to limit exposure to uncollectible advances.
- For purchased servicing rights and excess servicing fees, reviewing the assumptions used in the valuation process, considering their current reasonableness, and evaluating the effect of changes in assumptions on recoverability.
- Evaluating the adequacy of the liability for recourse obligations because of recourse provisions and the VA no-bid options. Loan sale/serv-

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[9] Paragraphs 5.99 and following provide guidance on evaluating the classification of securities, including MBSs.

icing agreements generally address recourse provisions and should be reviewed for all substantial investors to ensure that portfolios sold with recourse are included in reserve adequacy considerations. Chapter 7 provides further guidance on testing the allowance for loan losses.

Chapter 9

Real Estate Investments, Real Estate Owned, and Other Foreclosed Assets

Introduction

9.01 Generally, the largest component of real estate owned by banks and savings institutions is foreclosed real estate assets. Real estate investments, real estate loans that qualify as investments in real estate, and premises that are no longer used in operations may also be included in real estate owned.[1] Furthermore, institutions may obtain assets other than real estate through foreclosure, and those assets also are addressed in this chapter.

Foreclosed Assets

9.02 Foreclosed assets include all assets received in full or partial satisfaction of a receivable and include real and personal property; equity interests in corporations, partnerships, and joint ventures; and beneficial interests in trusts. Foreclosed assets also include loans that are treated as if the underlying collateral had been foreclosed because the institution has taken possession of the collateral, even though legal foreclosure or repossession proceedings have not taken place.[2]

Real Estate Investments

9.03 Some institutions make direct equity investments in real estate projects.

9.04 Further, in some loans accounted for as real estate investments, institutions have virtually the same risks and rewards as those of owners or joint venture participants. Such arrangements are treated as if the institution actually has an ownership interest in the property. In such arrangements the lender participates in expected residual profits, which may be in the form of an

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[1] In July 1994, the Accounting Standards Executive Committee (AcSEC) considered a final draft of a proposed Statement of Position (SOP), *Identifying and Accounting for Real Estate Loans That Qualify as Real Estate Investments*. At that time, there was not sufficient support to issue the final Statement and AcSEC is discussing various alternatives. Readers should be alert to the issuance of any final Statement.

[2] SOP 92-3, *Accounting for Foreclosed Assets*, was issued prior to Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*, which amended FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, prospectively. Paragraph 13 of FASB Statement No. 114 requires that, regardless of the measurement method, a creditor shall measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable. Further, paragraph 34 of FASB Statement No. 15, as amended, provides that a troubled debt restructuring (TDR) that is in substance a repossession or foreclosure by the creditor, that is, the creditor receives physical possession of the debtor's assets regardless of whether formal foreclosure proceedings take place, or in which the creditor otherwise obtains one or more of the debtor's assets in place of all or part of the receivable, shall be accounted for according to the provisions of paragraphs 28 and 33 and, if appropriate, 39 of FASB Statement No. 15.

equity kicker or a higher than usual effective interest rate. At the outset and during the construction and development of the property, the borrower generally has little or no equity in the property and the institution's only source of repayment is the property. The institution generally (*a*) agrees to provide substantially all funds to acquire, develop, and construct the property, (*b*) funds the commitment or origination fees or both, and (*c*) funds interest during the development and construction of the property.

Regulatory Matters

9.05 The agencies jointly issued a policy statement on June 16, 1993, that addresses treatment of sales of real estate owned for regulatory financial reporting purposes.

9.06 Office of Thrift Supervision (OTS) policy requires general valuation allowances on real estate owned for regulatory financial reporting purposes.

9.07 Voluntary direct investments in real estate are generally limited for national banks, as described in Chapter 7 of the Code of Federal Regulations.

Accounting and Financial Reporting

Foreclosed Assets

9.08 FASB Statements No. 15 and No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and SOP 92-3 establish guidance on accounting for and reporting of foreclosed assets.[3,4] At the time of foreclosure or physical possession, the asset should be reported at its fair value if it will be held and used or at its fair value less cost to sell if it will be disposed of.[5] Paragraphs 10 and 11 of SOP 92-3 state that there is a presumption that such assets are held for sale, which may be rebutted, except for in-substance foreclosed assets, by a preponderance of evidence. However, institutions would rarely be able to rebut the presumption for real estate assets, because regulations generally require them to divest of real estate owned within a short period of time.

9.09 FASB Statement No. 121 requires that long-lived assets to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets that are covered by Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations–Reporting the Effects of*

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[3] FASB Statement No. 121 is effective for financial statements for fiscal years beginning after December 15, 1995, with earlier application encouraged. Paragraph 34 of the Statement prohibits restatement of previously issued financial statements and requires that impairment losses resulting from application of the Statement be reported in the period in which the recognition criteria are first applied and met. Paragraph 35 requires that the initial application of the Statement to assets that are being held for disposal at the date of adoption be reported as the cumulative effect of a change in accounting principle.

[4] As explained below and in footnotes 6 and 7 herein, certain provisions of SOP 92-3 are inconsistent with provisions of FASB Statement No. 121. AcSEC is considering actions that should be taken on SOP 92-3; however, FASB Statement No. 121 takes precedence for transactions within its scope.

Paragraph 13 of SOP 92-3 requires that the amount of any senior debt to which a foreclosed asset is subject should be reported as a liability at the time of foreclosure and not be deducted from the carrying amount of the asset; principal payments on such debt should be charged to the liability. That paragraph further requires that interest that accrues after foreclosure should be recognized as interest expense.

[5] See paragraph 6.57.

Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions.[6] (Assets within the scope of APB Opinion 30 are reported at the lower of carrying amount or net realizable value.)

9.10 FASB Statement No. 121 requires that long-lived assets to be held and used by an institution be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.[7] FASB Statement No. 121 requires that, in performing the review for recoverability, the institution should estimate the future cash flows expected to result from the use of the asset and its eventual disposition. The Statement requires that, if the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, including related goodwill, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. The Statement requires that measurement of an impairment loss for long-lived assets that an institution expects to hold and use should be based on the fair value of the asset.

9.11 Foreclosed assets may be classified as a separate balance-sheet amount or included in other assets in the balance sheet, with separate disclosure in the notes to the financial statements.

Real Estate Investments

9.12 AICPA SOP 78-9, *Accounting for Investments in Real Estate Ventures*, and FASB Statements No. 34, *Capitalization of Interest Cost*, No. 58, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method*, No. 66, *Accounting for Sales of Real Estate*, and No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, establish generally accepted accounting principles (GAAP) for real estate investments.[8, 9]

9.13 The AICPA's Notice to Practitioners on acquisition, development, and construction (ADC) arrangements requires that certain ADC arrangements be accounted for as investments in real estate (in conformity with FASB Statements No. 66 and No. 67) or real estate joint ventures (in conformity with the provisions of SOP 78-9 and FASB Statement No. 34, as amended by FASB Statement No. 58) rather than as loans.[10] As discussed in the Notice to Practitioners, ADC arrangements accounted for as investments in real estate or real estate joint ventures should not be reported as loans in the balance sheet.

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[6] Paragraph 15 of SOP 92-3 requires that, after foreclosure, assets determined to be held for the production of income (and not held for sale) should be reported and accounted for in the same way that they would be had the assets been acquired other than through foreclosure.

[7] Paragraph 16 of SOP 92-3 requires that, if an institution subsequently decides that a foreclosed asset classified as held for sale will be held for the production of income, the asset should be reclassified from the held-for-sale category. The reclassification should be made at the amount the asset's carrying amount would have been had the asset been held for the production of income since the time of foreclosure. Selling costs included in the valuation allowance should be reversed. The net effect should be reported in income from continuing operations in the period in which the decision not to sell the asset is made.

[8] See footnote 1 in this chapter.

[9] AcSEC has a project under way that would amend SOP 78-9. Readers should be alert to any final pronouncement.

[10] The Notice appears as exhibit I in AICPA Practice Bulletin 1, *Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance*, and gives guidance on determining whether an ADC arrangement should be treated as an investment in real estate or as a loan. Chapter 6 on loans applies to ADC arrangements that are considered loans.

Sale of Real Estate Assets

9.14 FASB Statement No. 66 establishes GAAP for recognition of profit on all real estate sales transactions, including sales of foreclosed real estate assets. FASB Statement No. 66 provides criteria for determining whether a sale has occurred and, if so, the appropriate method of profit recognition. Further, FASB Statement No. 66 establishes GAAP for sale recognition for transactions that do not include gains. The six primary methods of accounting for sales transactions are full accrual, installment, percentage of completion, reduced profit, cost recovery, and deposit. Other guidance on accounting for real estate sales that may apply include the following matters discussed by the FASB's Emerging Issues Task Force (EITF).

- Issue No. 84-17, *Profit Recognition on Sales of Real Estate with Graduated Payment Mortgages or Insured Mortgages*
- Issue No. 86-6, *Antispeculation Clauses in Real Estate Sales Contracts*
- Issue No. 86-7, *Recognition by Homebuilders of Profit from Sales of Land and Related Construction Contracts*
- Issue No. 87-9, *Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds*
- Issue No. 87-29, *Exchange of Real Estate Involving Boot*
- Issue No. 88-12, *Transfer of Ownership Interest as Part of Down Payment under FASB Statement No. 66*
- Issue No. 88-21, *Accounting for the Sale of Property Subject to the Seller's Preexisting Lease*
- Issue No. 88-24, *Effect of Various Forms of Financing under FASB Statement No. 66*

Development Costs

9.15 Costs directly attributable to the acquisition, development, and construction of a real estate project should be capitalized in conformity with FASB Statement No. 67. Such costs include (*a*) options and other preacquisition costs, (*b*) direct project costs, (*c*) holding costs, including real estate taxes and insurance during the period in which activities of a substantive nature necessary to get the real estate ready for use are in progress, and (*d*) direct amenity costs, net of incidental operations during the holding period. A valuation allowance should be established for the excess of capitalized costs over the fair value of the foreclosed asset or the net realizable value of the real estate investment.

9.16 Whenever practical, costs including amenities should be allocated to components of a project on the basis of specific identification. If specific identification is not practical, (*a*) land costs and all other common costs incurred prior to construction should be allocated based on the relative fair value of each land parcel before construction and (*b*) construction costs should be allocated on the basis of the relative sales values of each unit. If allocation based on relative values is also impractical, costs should be allocated based on square footage or other methods as appropriate under the circumstances.

Allocation of Income and Equity Among Parties to a Joint Venture

9.17 When a real estate investment is made through a joint venture arrangement, a formal agreement generally exists that specifies key terms, such as profit or loss allocations, cash distribution, and capital infusion provisions. The terms of these agreements may affect the institution's investment valuation and, accordingly, should be considered in the investment evaluation process. Some joint venture agreements specify different ratios for allocating income, losses, cash distributions, liquidation distributions, and the like between partners. In these circumstances, accounting by investors for their equity in the venture's earnings under such agreements requires careful consideration of substance over form and a consideration of the underlying values. If a specified allocation has no substance (for example, all depreciation is to be allocated to one partner but all cash distributions, including proceeds from the sale of real estate, are shared equally by all partners), it should be ignored. The agreement should be analyzed to determine how changes in net assets of the venture will affect cash payments to investors over the venture's life and at liquidation. Paragraph 25 of SOP 78-9 provides further guidance on the allocation of income and equity among parties to a joint venture.[11] Specified profit and loss ratios should not be used to determine an investor's equity in venture earnings if the allocation of cash distributions and liquidating distributions are determined on some other basis.

9.18 The institution should consider whether it is appropriate to allocate to other partners losses in excess of their capital contributions or whether the institution should record losses in excess of its own investment, including loans and advances. Items that may affect the institution's decision are (*a*) the financial strength of the partners, (*b*) the type of partners (general versus limited) and the partners' legal requirement to fund losses, (*c*) the fair value of the real estate, and (*d*) the type of losses being incurred (cash or book). Paragraphs 14 through 20 of SOP 78-9 provide guidance on investor accounting for losses in such circumstances.

Auditing

Objectives

9.19 The primary objectives of audit procedures in the real estate investments, real estate owned, and other foreclosed assets area are to obtain reasonable assurance that—

a. The assets exist and are owned by the institution.

b. The assets are properly classified, described, and disclosed in the financial statements.

c. Adequate provisions have been made for impairment, if any, of the assets.

d. Depreciation expense, where applicable, and other revenues and expenses related to real estate assets are properly allocated and reported.

e. Sales of assets, including the recognition of gains and losses, have been recognized.

f. Appropriate disclosures have been made.

Planning

9.20 In planning the audit, the independent accountant should consider the following factors that may indicate higher inherent risk in this area:

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[11] See footnote 9 in this chapter.

- Adverse environmental or economic conditions that may affect real estate markets and the values and liquidity of properties or other assets
- Significant losses on past sales of real estate owned or other foreclosed assets
- Complex real estate assets
- Sales, financed by the institution, of real estate owned or other foreclosed assets
- Lack of experienced real estate staff
- High concentrations of real estate or other assets in a particular geographic area
- Significant fluctuations in the amount and number of foreclosures or in-substance foreclosures
- Inexperienced internal appraisal personnel or the use of low-quality or outdated appraisals

Internal Control Structure Over Financial Reporting and Possible Tests of Controls[12]

9.21 Inherent risk is often high for foreclosed assets and ADC arrangements because of the high degree of subjectivity involved in determining real estate values and the classification of ADC arrangements. However, with a high level of inherent risk in the real estate area, the independent accountant would often conclude that for most of the assertions it is more effective or efficient to assess control risk at the maximum and plan a primarily substantive approach, involving a selection of major real estate assets for detailed review.

9.22 Though a primarily substantive approach is often used to test individually significant real estate owned and other foreclosed assets, to plan the audit the independent accountant must obtain a sufficient understanding of the internal control structure over financial reporting of such assets. However, the independent accountant may deem it appropriate to obtain evidence to support a lower assessment of control risk for the purpose of determining the nature, timing, and extent of substantive procedures applied to pools of smaller-value assets (such as one- to four-family real estate, automobiles, recreational vehicles, and mobile homes). Internal controls over financial reporting of real estate investments, real estate owned, and other foreclosed assets generally include—

- Written policies and procedures, including those that address—
  - Frequency of appraisals and selection and qualifications of appraisers.

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[12] In December 1995, the Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). SAS No. 78 revises the definition and description of internal control contained in the SASs to recognize the definition and description contained in *Internal Control—Integrated Framework* published by the Committee of Sponsoring Organizations of the Treadway Commission. SAS No. 78 is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted.

In conjunction with SAS No. 78, the ASB issued Statement on Standards for Attestation Engagements (SSAE) No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2* (AICPA, *Professional Standards*, vol. 1, AT sec. 400). SSAE No. 6 conforms the description of elements of an entity's internal control to the components of internal control contained in SAS No. 78 and the *Internal Control—Integrated Framework*. SSAE No. 6 is effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, with earlier application permitted.

- — Disbursement of funds.
- — Evaluation of management companies.
- — Review and monitoring of marketing efforts.
- — Nature and amount of facilitating financing.
- — Revenue recognition.
- — Cost to sell.
- — Capitalization of interest.

- Proper authorizations for specific transactions.
- Periodic reviews of balances, fair values, realizable values, and policies by persons specified in management's written policy.

Substantive Tests

9.23 ***Other Real Estate Owned and Real Estate Investments.*** Obtaining evidential matter about the carrying amount of foreclosed assets (fair values) and real estate investments (including loans that qualify as real estate investments) may involve a review of appraisals, feasibility studies, forecasts, sales contracts or lease commitments, and information concerning the track record of the developer. In addition, the independent accountant should be alert to involvement of related parties and should design audit procedures accordingly. To obtain sufficient persuasive evidence of progress to completion under a real estate investment or other real estate project, the independent accountant may also decide to perform an on-site inspection of certain properties.

9.24 Substantive tests of other real estate and real estate investments generally focus on the valuation assertion; however, tests of the other assertions should also be considered. For example, evidence about the completeness assertion may be obtained through the independent accountant's testing of loans. In addition, the independent accountant should consider testing the propriety of gains and losses on real estate sales and capitalized interest and other holding costs.

9.25 Estimates of the fair value of real estate assets are necessary to account for such assets. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance on auditing accounting estimates (such as estimates of fair values). SAS No. 57 discusses how an independent accountant obtains an understanding of how management developed estimates, concentrating on the key factors and assumptions used. It also discusses how the independent accountant evaluates the reasonableness of those estimates.

9.26 Many fair values will be based on valuations by independent appraisers. In applying audit procedures to real estate, the independent accountant often relies on representations of independent experts, particularly appraisers and construction consultants, to assist in the assessment of real estate values. SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), and the AICPA Audit and Accounting Guide *Guide for the Use of Real Estate Appraisal Information* provide guidance in this area.

9.27 Independent appraisals may be considered acceptable audit evidence. The quality of appraisals varies, however, and in some instances the independent accountant may have reason to believe certain assumptions underlying appraisals are unrealistic. The independent accountant should understand and consider the approaches and assumptions used in obtaining the appraised value. Some matters that should be considered by the independent accountant when evaluating an appraisal are—

- A rise or decline in a particular market area not reflected in an appraisal may warrant that additional procedures, or perhaps a new appraisal, be performed.
- If the date of appraisal is substantially earlier than the audit date, a rise or decline in a particular market area between the two dates may warrant a new appraisal or the performance of additional procedures.
- Appraised values should be based on current market conditions and must be discounted for costs to complete and sell, as well as for carrying costs.
- The estimated selling prices should reflect the expectations of a sale in the reasonably near future—not in an indefinite future period.

9.28 Because of time and cost considerations, an institution may use various approaches to estimate value without using the services of an independent appraiser. In evaluating internally derived valuation data, the independent accountant should understand the methods and assumptions used and the qualifications of the individual performing the evaluation and should be aware of inherent subjective determinations in estimating value that may be significant to the valuation process. The independent accountant should consider the reasonableness of the assumptions and approach used and should test the information underlying the valuation. Further, the independent accountant may decide to engage an appraiser independent of the institution to test the institution's internally derived valuation. Despite the existence of an appraisal, in certain situations the independent accountant may wish to physically observe properties for the stage of completion, for deterioration, or for estimating the extent of occupancy.

9.29 The independent accountant should also evaluate whether significant real estate transactions qualify as sales in conformity with criteria set forth in FASB Statement No. 66.

9.30 ***Other Foreclosed Assets.*** The procedures discussed above may be applied to other foreclosed assets to the extent that the independent accountant deems necessary.

Chapter 10

Other Assets

Introduction

10.01 The following assets are among those frequently grouped as "other assets" in depository institutions' balance sheets; however, any that are individually material should be presented in the balance sheet as a separate amount:

- Accrued interest receivable (see chapter 5 for a discussion on securities and chapter 6 for a discussion on loans)
- Premises and equipment
- Other real estate, such as foreclosed assets (see chapter 9 for a discussion on real estate investments, real estate owned, and other foreclosed assets)
- Identifiable intangible assets, such as core deposit intangibles, and purchased credit-card relationships
- Goodwill
- Customers' liabilities on acceptances
- Deferred tax assets (which are addressed in chapter 14)

Premises and Equipment

10.02 Premises and equipment consist primarily of land, buildings, furniture, fixtures, equipment, purchased software, and leasehold improvements used in bank or savings institution operations. Such assets may be acquired directly or through a special-purpose subsidiary.

Identifiable Intangibles

10.03 Identifiable intangible assets may be acquired individually, as part of a group of assets, or in a purchase business combination. They include, among others, core deposit intangibles (the value of long-term deposit relationships), and credit-card customer lists (the value of long-term credit-card relationships).

Goodwill

10.04 Goodwill arises in a business combination accounted for under the purchase method. It represents the difference between the cost of an acquired company and the sum of the fair values of the tangible and identifiable intangible assets acquired less the fair value of the liabilities assumed.

Customers' Liabilities on Acceptances

10.05 Customer's liabilities on acceptances represent a customer's outstanding debt to the institution that resulted from a banker's acceptance transaction. A banker's acceptance is a short-term negotiable time draft drawn on and accepted by an institution.

Other Miscellaneous Items

10.06 Other items that may be classified with other assets include suspense accounts, accruals for miscellaneous fees, other prepaid expenses, and due bills.

Regulatory Matters

10.07 Institutions are generally limited in the amount of intangible assets that may be included in their regulatory capital. The agencies require purchased credit-card relationships to be recorded at an amount no greater than the discounted value of their future net servicing income. The agencies further limit the aggregate amount of such intangibles that may be included in regulatory capital. Also, the agencies generally require that intangible assets be amortized for regulatory reporting purposes over no more than fifteen years. The amortization period for core deposit intangibles of national banks is further limited to ten years. The Office of the Comptroller of the Currency (OCC) generally further limits the amortization period for purchased credit card relationships to ten years.

10.08 For regulatory financial reporting purposes, the Office of Thrift Supervision (OTS) permits negative goodwill to be offset against goodwill recorded as an asset under generally accepted accounting principles (GAAP) established in Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*. Consistent with GAAP, the other agencies require negative goodwill be reported as a deferred credit with no offset against goodwill recorded as an asset.

Accounting and Financial Reporting

Premises and Equipment

10.09 Banks and savings institutions account for premises and equipment in the same way that commercial enterprises account for property and equipment (fixed assets). Institutions carry premises and equipment on the balance sheet at cost less accumulated depreciation, and adjust the carrying amount for permanent impairments of value. Capital additions and improvements to premises should be capitalized, including construction period interest capitalized in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 34, *Capitalization of Interest Cost*. Net gains or net losses on dispositions should be reflected in non-interest income or non-interest expense. A description of the institution's depreciation and capitalization policies should be included in the notes to the financial statements.

10.10 Premises and equipment may include capital leases, which should be accounted for in accordance with FASB Statement No. 13, *Accounting for Leases*, and are subject to the requirements of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, for purposes of recognizing and measuring impairment. Consolidation of subsidiaries that own premises should be done in accordance with FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*.

10.11 FASB Statement No. 98, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, Initial Direct Costs of Direct Financing Leases*, provides guidance on how to account for sale-leaseback transactions, and the FASB's

Emerging Issues Task Force (EITF) has reached consensus on various sale-leaseback matters, such as—

- Issue No. 84-37, *Sale-Leaseback Transaction with Repurchase Option.*
- Issue No. 86-17, *Deferred Profit on Sale-Leaseback Transaction with Lessee Guarantee of Residual Value.*

10.12 The cost of purchased software should be capitalized when such computer software (other than purchased computer software to be sold, leased, or otherwise marketed) is to be used as a long-lived asset and depreciated over its estimated useful life on a basis similar to that used for the premises and equipment.[1, 2]

10.13 Premises and equipment are generally shown as a single caption on the balance sheet, net of accumulated depreciation and amortization, the amount of which must be disclosed either on the face of the balance sheet or in the notes to the financial statements. If the individual categories of assets are material, they should be disclosed on the face of the balance sheet or in the notes to the financial statements. The amount of assets under capitalized leases should be disclosed.

Intangible Assets

10.14 At the time of acquisition, intangible assets should be reported at their fair value. Chapter 16 discusses the initial valuation and recognition of intangibles in connection with a business combination.

10.15 FASB Statement No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions*, provides guidance on the appropriate amortization periods and methods for amortization for identified intangible assets and unidentified intangible assets that arise when the fair value of liabilities assumed exceeds the fair value of tangible and identifiable intangible assets acquired.

10.16 Identifiable intangible assets related to borrower or depositor relationships should be amortized over the estimated lives of the relationships that exist at the time of the acquisition without regard to new depositors or borrowers that may replace them. The amortization period and method should be determined separately for each identifiable intangible. The values assigned to those assets involve assumptions about future events, such as anticipated withdrawals of deposits. Therefore, it is important that the recoverability of such assets be evaluated at each balance-sheet date. For example, if a large segment or separable group of the operating assets of an acquired institution is sold, the portion of the intangible assets attributable to the assets sold should be included in the cost of the sale.

10.17 For unidentifiable intangible assets covered by FASB Statement No. 72, the intangible should be amortized to expense over a period no longer than the estimated remaining life of the long-term interest-bearing assets acquired, which should not exceed 40 years. If the assets acquired do not include a significant amount of long-term interest-bearing assets, goodwill should be amortized over a period not exceeding the estimated average remaining life of the existing customer base acquired. Goodwill not covered under

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[1] Accounting for the cost of purchased computer software to sold, leased, or otherwise marketed is established in FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed.*

[2] The Accounting Standards Executive Committee (AcSEC) has a project under way that may affect accounting for software costs. Readers should be alert to any final pronouncement.

FASB Statement No. 72 is generally amortized on the straight-line method over its estimated useful life. (Paragraph 10.07 discusses limitations on amortization periods for regulatory reporting purposes.)

Customers' Liabilities on Acceptances

10.18 Provisions for uncollectible amounts for customers' acceptance liabilities should be made, if necessary. Customers' liabilities on acceptances should be reported gross, rather than net of the related bankers' acceptance liability.

Impairment

10.19 Intangible assets, including goodwill, should be evaluated for impairment in conformity with paragraph 31 of APB Opinion No. 17, *Intangible Assets*, except as discussed in paragraphs 10.20 through 10.22.

10.20 FASB Statement No. 121 establishes the accounting for impairment of long-lived assets, certain identifiable intangibles and goodwill related to those assets to held and used and for long-lived assets and certain identifiable intangibles to be disposed of.[3, 4]

10.21 FASB Statement No. 121 requires that long-lived assets and certain identifiable intangibles to be held and used by an institution be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The Statement requires that, in performing the review for recoverability, the institution should estimate the future cash flows expected to result from the use of the asset and its eventual disposition. FASB Statement No. 121 requires that, if the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, including related goodwill, an impairment loss is recognized. Otherwise, an impairment loss is not recognized. The Statement requires that measurement of an impairment loss for long-lived assets that an institution expects to hold and use should be based on the fair value of the asset.

10.22 FASB Statement No. 121 requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell, except for assets that are covered by APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*. Assets within the scope of APB Opinion No. 30 are reported at the lower of carrying amount or net realizable value. Paragraph 32 of APB Opinion No. 17 provides guidance on accounting for goodwill related to assets to be disposed of.

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[3] FASB Statement No. 121 is effective for financial statements for fiscal years beginning after December 15, 1995, with earlier application encouraged. Paragraph 34 of the Statement prohibits restatement of previously issued financial statements and requires that impairment losses resulting from application of the Statement be reported in the period in which the recognition criteria are first applied and met. Paragraph 35 requires that the initial application of the Statement to assets that are being held for disposal at the date of adoption be reported as the cumulative effect of a change in accounting principle.

[4] The third sentence of Paragraph 3 of FASB Statement No. 121 says:
This Statement does not apply to financial instruments, long-term customer relationships of a financial institutions (for example, core deposit intangibles and credit cardholder intangibles), mortgage and other servicing rights, deferred policy acquisitions costs, or deferred tax assets.

Auditing

Objectives

10.23 The primary objectives of audit procedures applied to other assets are to obtain reasonable assurance that—

a. The assets exist and are owned by the institution.

b. The assets are properly classified, described, and disclosed in the financial statements.

c. Intangible assets are being amortized on a consistent basis over the estimated period of benefit.

d. Adequate provisions have been made for impairment, if any, of the assets.

e. Sales of assets, including the recognition of gains and losses, have been properly recognized.

f. Appropriate disclosures, including the existence of liens, have been made.

Planning

10.24 The nature, timing, and extent of tests that the independent accountant applies to achieve the audit objectives are based on, among other things, the independent accountant's assessment of inherent risk and control risk. Presented below are examples of factors that may indicate higher inherent risk or control risk—

- A current interest rate environment that may adversely affect the values of intangible assets that derive their value from (*a*) loan relationships or (*b*) from the timing and amount of future cash flows
- Loss of depositor relationships
- Operating losses
- Large unreconciled balances in suspense accounts
- Planned branch dispositions

Internal Control Structure Over Financial Reporting and Possible Tests of Controls[5]

10.25 Although a primarily substantive approach is often used to test most other assets, to plan the audit the independent accountant must obtain a sufficient understanding of the internal control structure over financial reporting of other assets. Such controls generally include—

- Written policies and procedures that, among other things, specify depreciation and amortization methods and periods.

[5] In December 1995, the Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). SAS No. 78 revises the definition and description of internal control contained in the SASs to recognize the definition and description contained in *Internal Control—Integrated Framework* published by the Committee of Sponsoring Organizations of the Treadway Commission. SAS No. 78 is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted.

In conjunction with SAS No. 78, the ASB issued Statement on Standards for Attestation Engagements (SSAE) No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2* (AICPA, *Professional Standards*, vol. 1, AT sec. 400). SSAE No. 6 conforms the description of elements of an entity's internal control to the components of internal control contained in SAS No. 78 and the *Internal Control—Integrated Framework*. SSAE No. 6 is effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, with earlier application permitted.

- Proper authorizations for specific transactions.
- Periodic reviews of balances, fair values, realizable values, and policies by persons specified in management's written policy.

Substantive Tests

10.26 ***Premises and Equipment.*** Substantive procedures used to test premises and equipment consist primarily of physical inspection, review of documents of title or other documents supporting the acquisition, tests of disposals and other adjustments, and reasonableness tests of depreciation. Similar procedures are often used to test the classification, recording, and disclosure of leased premises and equipment.

10.27 Independent accountants should be alert for signs that premises and equipment are no longer in use and consider tests to determine whether there are any undisclosed liens on premises and equipment. The independent accountant should also consider whether there are any permanent impairments of the premises and equipment. Computer hardware and software are particularly vulnerable to obsolescence and their valuation should be reviewed.

10.28 ***Identifiable Intangible Assets and Goodwill.*** Substantiating the amount of intangible assets requires careful judgment by the independent accountant. The independent accountant should determine that the amortization periods are reasonable and that the customer relationships from which the intangibles derive their value continue to exist at the balance-sheet date. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance on auditing accounting estimates (such as estimates of fair values). SAS No. 57 discusses how an independent accountant obtains an understanding of how management developed estimates, concentrating on the key factors and assumptions used, and evaluates the reasonableness of those estimates. In this area, such key factors and assumptions may include the ability of the assets to generate income in the future, the expected lives of loans, or expected withdrawal rates of deposits. The independent accountant should consider whether the assumptions continue to be reasonable and evaluate the effect of changes in assumptions on the recoverability of the assets.

10.29 ***Customers' Liabilities on Acceptances.*** Substantive tests that are performed on loans, such as confirmation and collectibility reviews, are generally used to test customers' liabilities on acceptances (see chapters 6 and 7).

10.30 ***Suspense Accounts.*** Suspense accounts usually contain amounts related to items recorded and held pending classification and transfer to the proper account and may originate from a variety of sources, such as loan remittances, branch clearing transactions, automated teller machine (ATM) transactions, and payroll transactions. The independent accountant should review the suspense account for material items remaining in the account at year-end. The independent accountant should also review for propriety entries made to clear suspense account items.

Chapter 11

Deposits

Introduction

11.01 Deposits are an important source of funds for banks and savings institutions. Deposits are often an institution's most significant liability and interest expense on deposits an institution's most significant expense. The predominance of negotiable certificates of deposit (CDs) and other kinds of interest-bearing deposits on which drafts can be made, the deregulation of interest rates paid on insured deposits, competition from mutual funds and other financial products, nondeposit liabilities as a source of funds, and liability management all have driven the offering of a wide range of deposit products having a variety of interest rates, terms, and conditions.

11.02 Deposits are generally classified by whether they bear interest, by their ownership (for example, public, private, interbank, or foreign), and by their type (for example, demand, time, or secured). A description of various deposit products follows.

Demand Deposits

11.03 Demand deposits (often called *transaction accounts* or *DDAs*) are accounts that may bear interest and that the depositor is entitled to withdraw at any time without prior notice. Checking and negotiable order of withdrawal (NOW) accounts are the most common form of demand deposits. Withdrawals are typically made through check writing, automated teller machines (ATMs), point-of-sale (POS) terminals, electronic funds transfers (EFTs), or preauthorized payment transactions. Deposits are generally made through direct deposit (such as of payroll amounts) or EFTs, or at ATMs or teller windows.

11.04 Further, an institution may issue a check drawn on itself for a variety of purposes, such as expense disbursements, loan disbursements, dividend payments, withdrawal of account balances, and exchange for cash with customers. These checks are generally referred to as official checks and may consist of cashier's, treasurer's, expense, and loan disbursement checks and money orders.

Savings Deposits

11.05 Savings deposits bear interest and have no stated maturity. Savings deposits include passbook and statement savings accounts and money-market deposit accounts (MMDAs). Withdrawals and deposits are typically made at ATMs or teller windows, by EFTs, or by preauthorized payments. Furthermore, MMDAs generally permit the customer to write checks, although the number of checks that may be written is limited by law.

Time Deposits

11.06 Time deposits (which include CDs, individual retirement accounts [IRAs], and open accounts) bear interest for a fixed, stated period of time.

11.07 CDs bear a stipulated maturity and interest rate, payable either periodically or at maturity. CDs may be issued in bearer form (payable to the holder) or registered form (payable only to a specified individual or entity) and may be negotiable or nonnegotiable (always issued in registered form). Negotiable CDs, for which there is an active secondary market, are generally short-term and are most commonly sold to corporations, pension funds, and government bodies in large denominations (generally, $100,000 to $1 million). Nonnegotiable CDs, including savings certificates, are generally in smaller denominations. Depositors holding nonnegotiable CDs may recover their funds prior to the stated maturity but must pay a penalty to do so.

11.08 Retirement accounts known as IRAs, Keogh accounts (also known as HR 10 plans), or self-employed-person accounts (SEPs) are generally maintained as CDs. However, because of the tax benefits for depositors, they typically have longer terms than most CDs. Many retirement accounts provide for automatic renewal on maturity.

11.09 Open accounts are time deposits with specific maturities and fixed interest rates but, unlike savings certificates, amounts may be added to them until maturity. Common types of open accounts are vacation and Christmas club accounts.

11.10 Brokered deposits are time deposits that are third-party deposits placed by or through the assistance of a deposit broker. Deposit brokers sometimes sell interests in placed deposits to third parties. As discussed below, federal law restricts the acceptance and renewal of brokered deposits by an institution based on its capitalization.

11.11 Employers that withhold federal taxes from employees' pay are required to deposit those funds periodically with a depository institution. Banks and savings institutions record such deposits, which are non-interest-bearing, as treasury tax and loan accounts (TT&L accounts) and include such accounts with their deposits. (See paragraph 13.09.)

Dormant Accounts

11.12 Institutions generally have a policy on classifying accounts as dormant. The required period of inactivity before savings accounts are classified as dormant normally exceeds that for checking accounts because savings accounts are normally less active. After a specific period of inactivity, as determined by the state in which the institution is located, the accounts may no longer be deposits of the institution and may be required to be turned over to (escheat to) the state.

Closed Accounts

11.13 When an account is closed, the signature card is generally removed from the file of active accounts and placed in a closed-account section. Generally, account records are perforated in a canceling machine and returned to the depositor.

Other Deposit Services

11.14 Institutions often offer other deposit services such as reserve or overdraft checking (which combine a checking account and a preauthorized personal loan), check guarantee services, and consolidated account statements (which combine the account information of several services into one monthly statement).

The Payments Function and Services

11.15 The payments function of a bank or savings institution involves facilitating money payments and transferring funds. The payments function is accomplished through checks and EFTs.

11.16 ***Check Processing.*** The check-clearing process, which is highly automated, involves the exchange of checks and the settlement of balances among institutions locally, regionally, and nationally. Check processing involves encoding of checks with magnetic ink character recognition (MICR) symbols to facilitate routing, the proof and transit function, and the flow of checks for collection. A correspondent system and the Federal Reserve perform such clearinghouse functions for depository institutions.

11.17 An institution receives two types of checks: (*a*) on-us checks, drawn on a depositor's account and (*b*) foreign checks, drawn on accounts of other institutions. Such checks may be received from the Federal Reserve, local clearinghouses, other depository institutions, at an ATM or teller window, through the mail, or by other means, such as a loan payment.

11.18 Many checks that an institution receives have been dollar-amount encoded by the first institution that handles the check. However, checks received through an institution's own operations must go through its proof department or its correspondent bank. A proof department has the responsibility to—

a. Prove the individual transaction against its documentation, such as a deposit slip.

b. Verify totals for several departments.

c. Encode the dollar-amount field.

d. Mechanically endorse the back of the check.

e. Sort the items according to destination.

11.19 The flow of checks for collection depends primarily on the location of the institution on which the check is drawn. Processing an on-us check for deposit to another account in the same institution is straightforward: The institution debits the check writer's account and credits the check depositor's account. Processing a check drawn on another depository institution, however, can be complex.

11.20 Though some direct collections are made in the banking system, most institutions collect foreign checks through a clearing arrangement (clearinghouse), a correspondent bank, or the Federal Reserve.

11.21 In a clearing arrangement, a group of depository institutions in a given area that receive large numbers of deposited checks drawn on one another meets to exchange and collect payment for the checks. Checks are physically exchanged among participants, and collection is made by crediting or debiting the net amount presented by each institution against all the others.

11.22 When a correspondent institution receives a check drawn on one of its respondent institutions, the check collection process can take several different routes. If the presented check is drawn on an institution that also maintains an account with the correspondent, collection simply involves the correspondent's transfer of deposit credit from one account to another account.

If the check is drawn on an institution that does not have an account relationship with the correspondent, the check is credited to the respondent institution's account and then either (*a*) sent to a second correspondent in which the first correspondent and the institution on which the check is drawn both have an account, (*b*) sent to a local clearinghouse, or (*c*) sent to a Federal Reserve bank.

11.23 The Federal Reserve collects checks by internally transferring credit balances from one account to another, in much the same way that individual institutions collect on-us checks. For presenting and paying institutions that have accounts at two different Federal Reserve banks, an extra step is involved in the collection process. Each Federal Reserve bank has an interdistrict settlement account that it maintains on the books of the Interdistrict Settlement Fund established in Washington, D.C., to handle settlements. A check presented to one Federal Reserve bank drawn on a depository institution in another Federal Reserve district will result in a transfer of interdistrict settlement account balances from one Federal Reserve bank to another.

11.24 ***Electronic Funds Transfer (EFT) Systems.*** Banks and savings institutions have responded to the large volume of checks and the high costs of clearing checks by increasingly using EFT systems. EFT systems are computer-based networks designed to move funds to and from accounts and to and from other institutions electronically, thus eliminating paper-based transactions. Banks and savings institutions transact an enormous volume of daily business between themselves and for customers over regional and national EFT systems. The three principal kinds of EFT systems are direct deposit systems, automated clearinghouse (ACH) systems, and ATMs.

11.25 A direct deposit system involves the direct deposit of payments into a customer's account without the use of a definitive check and is widely used for payrolls. The payment information is usually transmitted to the institution from the payer in electronic form and processed through the institution's proof system.

11.26 An ACH is used to transfer funds from one institution's account at a Federal Reserve bank to that of another; conduct transactions in the federal funds market; transfer funds for customers; transfer book entries representing certain securities; and receive, send, and control other specific EFT messages between member banks and other clearinghouses. The largest ACH is Fedwire, operated by the Federal Reserve. The Clearing House Interbank Payments System (CHIPS) is an ACH operated by the New York Clearing House Association and is the focal point for payments in the world's international dollars market. International dollar payments generally do not leave the United States but are held as deposits at money-center and regional banks or the U.S. branches of foreign banks and are transferred between accounts through CHIPS in payment for internationally traded goods and services, international financial transactions, or settlement of debt.

11.27 Banks and savings institutions also provide a variety of retail EFT services, including ATMs, POS terminals, telephone bill payment, and home computer banking.

Regulatory Matters

11.28 Section 29 of the Federal Deposit Insurance (FDI) Act (codified in Title 12 of the Code of Federal Regulations [12 CFR] Part 337) significantly limits the acceptance or use of brokered deposits by depository institutions other than those that are well capitalized (as defined for purposes of prompt corrective regulatory action, as discussed in chapter 2). Adequately capitalized institutions may accept brokered deposits only if they first obtain a waiver from the Federal Deposit Insurance Corporation (FDIC). Undercapitalized institutions are prohibited from accepting brokered deposits. Restrictions on the acceptance of brokered deposits, particularly for institutions that become undercapitalized, could affect an institution's liquidity. The effect of such restrictions on liquidity may be a condition, when considered with other factors, that could indicate substantial doubt about an entity's ability to continue as a going concern (see chapter 3).

11.29 Section 29 also limits the interest rates that may be offered by under- or adequately capitalized institutions. Undercapitalized institutions may not solicit any deposits by offering rates significantly higher (as defined) than prevailing rates. Adequately capitalized institutions are prohibited from paying interest on brokered deposits above certain levels.

Accounting and Financial Reporting

11.30 The institution's liability for deposits originates and should be recognized at the time deposits are received rather than when the institution collects the funds. Checking accounts that are overdrawn should be reclassified as loans and should therefore be evaluated for collectibility as part of the evaluation of credit loss allowances.

11.31 Checks that are deposited by customers and that are in the process of collection and are currently not available for withdrawal (deposit float) should be recorded as assets and liabilities. Deposits should not be recorded based solely on collections.

11.32 Disclosures about deposits should generally include the following:

a. The aggregate amount of time deposit accounts (including CDs) exceeding $100,000 at the balance-sheet date

b. For time deposits having a remaining term of more than one year, the aggregate amount of maturities for each of the five years following the balance sheet date (in conformity with paragraph 10b of Financial Accounting Standards Board [FASB] Statement of Financial Accounting Standards No. 47, *Disclosures of Long-Term Obligations*)

c. Securities, mortgage loans, or other financial instruments pledged as collateral for deposits

d. The aggregate amount of any demand deposits that have been reclassified as loan balances at the balance-sheet date

e. The amount of deposits of related parties at the balance-sheet date (in conformity with FASB Statement No. 57, *Related Party Disclosures*)

f. Deposits that are received on terms other than those available in the normal course of business

g. The fair values of deposits (in conformity with FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*)

11.33 For deposits payable on demand or with no defined maturities, the fair value disclosed would be the amount payable on demand at the reporting date.

Auditing

Objectives

11.34 The primary objectives of auditing procedures for deposit liabilities are to obtain reasonable assurance that—

a. Financial statement amounts for deposit liabilities and related transactions include all deposit obligations of the institution and reflect all related transactions for the period.

b. Deposit liabilities and related income statement and balance-sheet accounts have been properly valued, classified, and disclosed in conformity with generally accepted accounting principles (GAAP).

Planning

11.35 The following factors related to deposits contribute to higher inherent risk:

a. Recurring and significant difficulties in reconciling exception items

b. A practice of permitting depositors to withdraw funds from their accounts before deposited checks have been collected by the institution

c. Introduction of new deposit products

d. Use of derivative financial instruments to hedge deposits

e. Significant changes in the amount and activity of previously inactive or dormant accounts

f. Significant increases in the number of closed accounts, especially near the end of a reporting period

g. Numerous accounts having instructions not to mail account statements to the depositor (*no-mail* accounts)

Internal Control Structure Over Financial Reporting and Possible Tests of Controls[1]

11.36 An effective internal control structure (as it relates to financial reporting of deposits) should provide reasonable assurance that (*a*) deposits are accepted in accordance with management's established policies, (*b*) errors and irregularities in the processing of accounting information for deposits are prevented or detected, and (c) deposits are monitored on an ongoing basis to determine whether recorded financial statement amounts require adjustment.

[1] In December 1995, the Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). SAS No. 78 revises the definition and description of internal control contained in the SASs to recognize the definition and description contained in *Internal Control—Integrated Framework* published by the Committee of Sponsoring Organizations of the Treadway Commission. SAS No. 78 is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted.

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11.37 The independent accountant's assessment of control risk for deposits should include consideration of whether the institution has internal control structure procedures that contribute to a strong control environment, which may include—

- Policies and procedures approved by the board of directors and that include position limits for each type of deposit (including brokered deposits) and guidelines for setting the interest rates offered on deposits.
- Segregation of duties between persons involved with the proof function, persons having access to cash, persons responsible for opening new accounts and issuing CDs or savings certificates, persons with responsibility for authorizing account adjustments, and persons with responsibility for posting information to the general ledger. (Because many of the potential duty conflicts found in the deposits area also exist for cash, it is usually efficient to coordinate any assessment of segregation of duties in those two areas.)
- Reconciliation of subsidiary ledgers for deposit principal, accrued interest, and related accounts to the general ledger on a periodic basis.
- Daily performance of a proof and transit operation with rejected or exception items segregated and individually reviewed. Examples of such items include activity in dormant accounts or customer overdrafts.
- Designation by management of persons such as officers or supervisory employees, to be responsible for reviewing and approving unposted holdover items, overdrafts, return items, and status of inactive or dormant accounts.
- Files, ledger cards, canceled checks, deposit tickets, signature cards, and unissued CDs and savings certificates safeguarded from unauthorized access (including dual control over and prenumbering of unissued certificates and official checks).
- Periodic depositor account statements mailed regularly. Returned statements are controlled, with follow-up on a timely basis.
- Supervisory personnel designated by management to be responsible for periodically reviewing activity in employee accounts for unusual transactions.
- EFTs subject to control procedures that—
  - — Segregate duties between employees who handle cash, balance EFT transactions, authorize EFTs, and post EFTs to deposit accounts.
  - — Require authorization for EFTs exceeding a depositor's available balance.
  - — Establish and maintain current, written agreements with all depositors making EFT requests, particularly for those customers who initiate EFT requests by telephone, modem, or other means not involving signed authorization. These agreements generally should be required to set forth the scope of the institution's liability and the agreed-upon security procedures for authenticating transactions (such as callbacks or passwords).
  - — Provide for review of rejected transactions and the correction and reversal of entries by a supervisor.
  - — Restrict initiation of EFTs and access to computer terminals or other EFT equipment.

- — Require that documentation of EFTs is provided to the parties involved on a timely basis.
- — Disclose the name of the debit party to the receiver of funds.
- — Provide for written instructions to employees and users concerning the EFT function.
- — Provide for use and confidentiality of authorized caller and other access codes or authentication algorithms, including periodic changes in such codes or algorithms.
- — Provide for maintenance of a current list of personnel authorized to initiate EFTs.
- — Establish authorization limits for personnel.
- — Provide for holds to be placed on customer accounts by EFT personnel when instructions are received directly from the authorized customer to confirm that available funds are in the customer's account or that the EFT funds are within authorized limits before the EFT is made.
- — Provide for maintenance of card files or authorization letters on file for all customers who initiate EFTs.

- Controls and verification procedures over requests for EFTs in place at respondent depository institutions.

11.38 The independent accountant may decide to perform procedures to obtain evidential matter about the effectiveness of both the design and operation of internal control structure policies and procedures to support a lower level of assessed control risk. Examples of tests of controls might include—

- Observing or otherwise obtaining evidence about segregation of duties and supervisory review of activity in employee accounts.
- Testing reconciliations of related accounts, including disposition of reconciling items and review and approval by a person other than the preparer.
- Testing controls over origination of and access to signature cards and mailing address files.
- Testing controls over the direct mailing of statements to depositors.
- Comparing withdrawal slips with the applicable signature cards.
- Testing controls over restrictions on deposits pledged as collateral, inactive or dormant accounts, and mail receipts.

11.39 Tests of internal control structure policies and procedures related to EFTs might include—

- Testing compliance with management's established authorization and verification procedures.
- Validating sequence numbers on transfers sent and received.
- Confirming that acknowledgments are returned for all outgoing messages.
- Reviewing management's daily comparison of the total number and dollar amount of EFTs sent and received with summaries received from the Federal Reserve.
- Testing reconciliations of daily reserve or clearing account statements for disposition of reconciling differences and supervisory review and approval.
- Testing procedures for identification and verification of EFTs with respondent institutions.

- Observing internal control structure procedures over access.

Substantive Tests

11.40 Audit procedures for deposits may include testing reconciliations of related subsidiary and general ledger accounts, confirmation of account balances, and analytical procedures.

11.41 ***Subsidiary Records and Reconciliations.*** Procedures should be planned that provide reasonable assurance that the subsidiary ledger information to be confirmed and tested has been recorded properly in the general ledger. The disposition of reconciling items between general and subsidiary ledgers (such as returned items, adjustment items, holdovers, overdrafts, and service charges) should be investigated to determine whether any adjustments to recorded amounts are necessary.

11.42 ***Confirmations.*** Guidance on the extent and timing of confirmation procedures is found in SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350), and SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312). Guidance on planning, performing, and evaluating samples is included in SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AICPA, *Professional Standards*, vol. 1, AU sec. 313, "Substantive Tests Prior to the Balance Sheet Date"). Confirmation of deposits provides evidence about existence and accuracy. Because independent accountants are generally more concerned with the completeness of recorded deposits, the independent accountant should consider performing other substantive procedures. It would be appropriate for the independent accountant to use the negative form of confirmation request only when the combined assessed level of inherent and control risk is low and the independent accountant has no reason to believe that the recipients will not consider the requests (see SAS No. 67, *The Confirmation Process* [AICPA, *Professional Standards*, vol. 1, AU sec. 330], for additional guidance). If confirmations are used, active, inactive, and dormant accounts, and accounts closed during the period, should all be included in the population subject to audit procedures.

11.43 Some depositors may have instructed the institution not to send account statements to the depositor's mailing address. For such *no-mail* accounts, the independent accountant should review a written request from the depositor requesting the no-mail status and should use alternative procedures to obtain adequate evidence about the account balance. No-mail accounts and accounts for which confirmation requests are returned undelivered should be subjected to alternative procedures (such as personal contact with the depositor). (See paragraphs 31 and 32 of SAS No. 67 for additional guidance.)

11.44 ***Accrued Interest Payable, Interest Expense, and Service Charge Income.*** Audit procedures should be performed on accrued interest payable, interest expense, and service charge income in connection with other procedures on deposits. Audit procedures for such amounts include reviewing and testing reconciliations of subsidiary ledgers with the general ledger, recalculating interest paid, accrued interest payable, and service charge income, and testing of interest expense and service charge income for the period.

11.45 ***Other Analytical Procedures.*** Analytical review procedures can provide substantive evidence about the completeness of deposit-related financial statement amounts and disclosures; however, such procedures in tests of deposit expense are often less precise than substantive tests such as recalculations. Because institutions generally offer a wide variety of deposit products and rates (which change frequently during a financial reporting period), it is normally difficult to develop expectations to be used in analyzing yields on deposits. Accordingly, analytical procedures in this area should generally be considered only as a supplement to other substantive procedures, except where an expected yield can be known with some precision. Further guidance is provided in SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), and SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326). The independent accountant should be careful not to view trends entirely from a historical perspective; current environmental and business factors as well as local, regional, and national trends should be considered to determine if the institution's trend appears reasonable. Some analytical review procedures that should be considered include—

- Comparing the percentage of deposit growth during the period with historical percentages.
- Comparing the average deposit account balances during the period with those of prior periods.
- Reviewing the relative composition of deposits from period to period.
- Comparing the amounts and percentage ratio of dormant accounts to total deposits with those of prior periods.
- Comparing deposit interest rates with those prevailing in the institution's marketing area for the same periods.

Chapter 12

Federal Funds and Repurchase Agreements

Introduction

12.01 This chapter addresses two types of transactions—federal funds and repurchase agreements—that can be either investing or financing transactions, depending on which side of the transaction the bank or savings institution participates. Federal funds transactions can be an important tool for managing liquidity. Repurchase agreements also can provide a cost-effective source of funds and may provide a means for the institution to leverage its securities portfolio for liquidity and funding needs.

Federal Funds Purchased

12.02 Federal funds are funds that commercial banks deposit at Federal Reserve Banks. Banks must meet legal reserve requirements on a daily basis by maintaining a specified total amount of deposits at Federal Reserve Banks and vault cash. A bank with excess reserves on a particular day may lend the excess, at an agreed rate of interest (the federal funds rate), to another bank needing funds to meet its reserve requirements that day. The federal funds market does not increase or decrease total reserves in the Federal Reserve System, but merely redistributes them to facilitate efficient use of bank reserves and resources. However, by setting reserve requirements the Federal Reserve may increase or decrease total reserves in the system. No physical transfer of funds takes place; the Federal Reserve Bank charges the seller's reserve balance and credits the buyer's reserve balance. In addition to buying and selling funds to meet their own needs, banks with correspondent banking relationships absorb or provide funds as a service or accommodation to their correspondents. Accordingly, banks may operate on both sides of the federal funds market on the same day.

12.03 Two types of transactions involving federal funds are commonly used. In an unsecured transaction, the selling bank sells federal funds on one day and is repaid with interest at maturity (usually the next day). In a collateralized transaction, other than by a repurchase agreement, a bank purchasing federal funds places U.S. government securities in a custody account for the seller until the funds are repaid. A borrowing bank records a liability (federal funds *purchased*) and a selling bank records an asset (federal funds *sold*).

Repurchase Agreements[1]

12.04 An institution that sells securities and agrees to repurchase the identical (or substantially the same) securities at a specified date for a specified

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[1] In October 1995, the Financial Accounting Standards Board (FASB) issued a proposed Statement, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The proposed Statement would significantly affect accounting for (including disclosures about) sales of partial interests, servicing assets and liabilities, securities lending transactions, repurchase agreements, "wash sales," loan syndications and participations, risk participations in banker's acceptances, factoring arrangements, and transfers of receivables with recourse. Comments on the proposal were due in January 1996. Readers should be alert to any final pronouncement.

price has entered into a repurchase agreement, or repo,[2] as a seller-borrower. Alternatively, an institution may participate as a buyer-lender by agreeing to purchase and resell at a specified future date for a specified price. Most repos involve obligations of the federal government or its agencies, but other financial instruments, such as commercial paper, banker's acceptances, and negotiable certificates of deposit (CDs), are sometimes used in repos. Repos are similar to the seller-borrower's borrowing funds equal to the sales price of the related securities with the securities as collateral. The difference in the price at which the institution sells its securities and repurchases them represents interest for the use of the funds. Most repo transactions occur with other depository institutions, dealers in securities, state and local governments, and customers (retail repurchase agreements). Maturities of such agreements are flexible and generally vary from one day to 270 days.

12.05 Dollar repurchase agreements (also called *dollar rolls*) are agreements to sell and repurchase similar but not identical securities. The dollar roll market consists primarily of agreements that involve mortgage-backed securities (MBSs). Dollar rolls differ from regular repurchase agreements in that the securities sold and repurchased, which are usually of the same issuer, are represented by different certificates, are collateralized by different but similar mortgage pools (for example, single-family residential mortgages), and generally have different principal amounts. The most common types of dollar rolls are fixed-coupon and yield-maintenance agreements.

12.06 In a fixed-coupon agreement, the securities repurchased have the same stated interest rate as, and maturities similar to, the securities sold and are generally priced to result in substantially the same yield. The seller-borrower retains control over the future economic benefits of the securities sold and assumes no additional market risk.

12.07 In a yield-maintenance agreement, the securities repurchased may have a different stated interest rate from that of the securities sold and are generally priced to result in different yields as specified in the agreement.[3] The seller-borrower surrenders control over the future economic benefits of the securities sold and assumes additional market risk. Yield-maintenance agreements may contain par cap[4] provisions that could significantly alter the economics of the transactions.

12.08 The terms of the agreements often provide criteria to determine whether the securities are similar enough to make the transaction, in substance, a borrowing and lending of funds or whether the securities are so dissimilar that the transaction is a sale and purchase of securities. For agreements involving securities collateralized by dissimilar pools, those transactions are accounted for as sales and purchases of securities.

12.09 ***Rollovers and Extensions.*** Occasionally, securities involved in repos are not delivered on the settlement date of the agreement and the con-

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[2] Banks and broker-dealers (and this Guide) refer to agreements by seller-borrowers to sell and repurchase securities as repurchase agreements (repos) and agreements by buyer-lenders to purchase and resell securities as reverse repurchase agreements (reverse repos). Savings institutions have in the past used the opposite terms, calling a seller-borrower's agreement a reverse repurchase agreement and a buyer-lender's agreement a repurchase agreement.

[3] The price-spread relationship between securities with different contract interest rates does not move in tandem. The existence of yield and price disparities provides opportunities for the buyer-lender to deliver, within the terms of the agreement, certificates providing the greatest benefit to the buyer-lender.

[4] A par cap provision limits the repurchase price to a stipulated percentage of the face amount of the certificate. Fixed-coupon agreements do not contain par cap provisions.

tract may be rolled over or extended upon mutual agreement of the buyer-lender and seller-borrower.

12.10 ***Breakage.*** Securities repurchased under repos commonly have a principal amount that differs from the principal amount of the security originally sold under the agreement. This is particularly common to dollar rolls, which involve MBSs. That difference is referred to as *breakage* and occurs because the principal amounts of MBSs generally differ as a result of the monthly amortization of principal balances of mortgages collateralizing the MBSs. The amount of the breakage is a factor in determining whether substantially the same security is reacquired in the repo transaction, that is, whether good delivery (one in accordance with the agreement terms) has been met on repurchase of the MBSs.

12.11 ***Business Risk.*** Business risks associated with repos include the contractual and economic complexities inherent in certain of these transactions and the corresponding risk associated with the degree to which the institution's management understands the terms of the agreements and the economics of the transactions. Misunderstandings may result in incorrect pricing of the agreements or an incorrect assessment of the risks that are being assumed, the return that is anticipated to be earned, or the financing costs that are being incurred. Misunderstandings of the terms may also result in improper accounting treatment of the transaction (that is, as a sale and purchase or as a financing).

12.12 ***Market Risk.*** The prices of government securities vary inversely with changes in interest rates. Price changes may be small, but they can result in significant changes in the market values of government securities due to the large dollar amounts often involved in government securities transactions. This is generally referred to as *market risk*. Price changes may affect the ability of the seller-borrower under repos to continue the financing without providing additional collateral. Changes in prices also affect the margin in a transaction and may create a need for the seller-borrower to transfer additional securities or return cash.

12.13 The excess of the market value of the securities transferred by the seller-borrower over the amount of cash transferred by the buyer-lender is called a *haircut*. A haircut represents a margin of safety required by the buyer-lender to guard against a decline in the value of the collateral as a result of rising interest rates during the term of the agreement. Whether an agreement provides for a haircut depends on competition among buyer-lenders and seller-borrowers and their relative bargaining strengths. Haircuts generally range from a fraction of 1 percent to 4 percent or 5 percent but may be higher in certain instances.

12.14 All of the following factors are considered in determining the haircut for a particular transaction:

a. The term of the agreement

b. The creditworthiness of the institution

c. The type of securities underlying the agreement, the length of time to maturity, and the creditworthiness of the issuer of the securities

d. The volatility of the market value of the underlying securities

e. The differential between the interest rate specified in the agreement and the interest rate on the securities

12.15 ***Credit Risk.*** A repo or reverse repo can be considered a loan of cash by one party and a loan of securities by another. When the agreement is completed, both loans are repaid. Parties to repo and reverse repo transactions are subject to credit risk, that is, the risk that the transaction counterparty will not perform under the terms of the agreement. For example, a seller-borrower is at risk that changes in market prices and resulting economic losses may prevent the buyer-lender from returning the securities at the maturity of the agreement.

12.16 Credit risk also exists to the extent that the issuer of the underlying securities may default. However, such risk may be negligible for securities issued or guaranteed by the U.S. government or its agencies. If the issuer of the underlying securities defaults, both participants in the repo are obligated to complete the transaction. This aspect of credit risk is affected by the extent to which the institution's repo position is concentrated in any one type of underlying security or with any one counterparty.

12.17 The extent of credit risk faced by a seller-borrower also depends on the buyer-lender's business policies and practices for control and use of collateral, the extent of the haircut on securities serving as collateral, the extent to which the buyer-lender offsets transactions (that is, maintains a matched book), and the buyer-lender's extent of capitalization.

12.18 Analyzing credit risk requires an understanding of how securities dealers and other counterparties to repos manage their businesses and of the steps that can be and are taken to reduce their exposure to market risk. Securities dealers are typically highly leveraged, with securities positions that represent large multiples of their net capital and that can quickly be eroded by adverse market changes. Many securities dealers entering into repos frequently employ matched-book transactions. In a matched-book transaction, the securities dealer effects both a repo and a reverse repo with the same underlying securities for the same period of time but usually at slightly different rates. By running a matched book, a dealer can reduce its exposure to market changes, and a seller-borrower may face less credit risk by entering into agreements with a dealer that has a matched book and employs adequate procedures to control credit risk. Even if the dealer runs a matched book, the seller-borrower still faces credit risk associated with the dealer's credit risk, that is, the risk that a customer of the dealer might not be able to complete its agreement with the dealer.

12.19 ***Risk of Collateral Loss.*** When an institution transfers the securities sold under an agreement to repurchase, there is a risk that the dealer may not be able to reverse the transaction by selling the securities back at the agreed price. If the institution overcollateralizes the agreement by selling the securities at a relatively large discount from the market price, its rights to the overage may be diminished or lost entirely in the event of the dealer's bankruptcy. In that case, the institution may find that neither the securities nor the funds to replace the securities are available for the dealer to complete the transaction and, as a result, may incur an economic loss. If the institution does not have the legal right of setoff, the potential economic loss extends to the full value of the securities, including accrued interest.

12.20 If the institution has the legal right to set off the securities against the borrowed funds, the potential economic loss is limited to the excess of the market value of the securities, plus accrued interest, at the date of the sale over the amount borrowed, plus or minus any change in that market value and accrued interest. However, the accounting loss may be greater or less than the economic loss if the book value of the securities is above or below their market value. (See paragraph 12.23.)

12.21 Securities purchased under agreements to resell (reverse repos) pose risk to buyer-lenders to the extent that they do not take possession of the securities they agreed to resell. If the buyer-lender or securities dealer through whom the transaction is made does not perfect a security interest in securities purchased (by having signed an agreement and by taking possession, either directly or through a custodian acting as its agent), the potential economic loss extends to the full value of the securities and the risk assumed—namely, credit risk—becomes that of an unsecured lender. Institutions reduce such risk *(a)* by making sure that definitive collateral is held by the counterparty's custodian as the counterparty's agent with specific identification of the assignee, *(b)* by settling through the Federal Reserve System, where book-entry collateral is transferred directly or by a notation entry, *(c)* by evaluating the creditworthiness of the other party to the agreement, and *(d)* by overcollateralizing the borrowing.

Regulatory Matters

12.22 The Office of the Comptroller of the Currency (OCC) requires that, for regulatory financial reporting purposes, securities sold under a repo should be recorded as sales (or purchases) when the repo either matures at the same time as the underlying security or has a maturity date that exceeds 50 percent of the remaining maturity of the underlying security at the time the institution enters into the repo.

Accounting and Financial Reporting

12.23 Banks and savings institutions may operate on both sides of the federal funds and repo markets on the same day. Accounting Principles Board Opinion No. 10, *Omnibus Opinion—1966*, paragraph 7 says that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a *right of setoff* exists." FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, defines right of setoff and specifies conditions that must be met to permit offsetting. FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*, modifies FASB Interpretation No. 39 to permit offsetting in the statement of financial position of only payables and receivables that represent repos and reverse repos and that meet all of the conditions specified therein and does not apply to securities borrowing or lending transactions.[5]

Seller-Borrower's Transaction

12.24 Federal funds purchased and repos accounted for as borrowings are usually combined and displayed immediately after deposits on the balance sheet.

12.25 Repos may be treated as collateralized borrowings or as a sale and subsequent repurchase of securities. The key factor in distinguishing between

[5] See footnote 1 in this chapter.

the sale and repurchase of securities and a financing arrangement for accounting purposes is the degree of control over the future economic benefits relating to the securities sold and reacquired by the seller-borrower. If the security sold is the identical security repurchased, as in a repo, the seller-borrower has retained control over the future economic benefits relating to the security and has assumed no additional market risk (assuming there are no provisions in the agreement to the contrary). Thus, the transaction is generally accounted for as a financing arrangement.

12.26 In a dollar roll, the degree of control over the future economic benefits relating to the security transferred depends on whether the security delivered back is substantially the same as the security sold. If the delivered security is not substantially the same as the security originally transferred (sold), the seller-borrower has surrendered control over the future economic benefits relating to the original security and become exposed to market risk, and the transaction should therefore be accounted for as a sale and repurchase. Fixed-coupon dollar repos should be reviewed carefully to determine if the securities given up and repurchased represent substantially the same securities to ensure that their treatment as a financing transaction is proper. Specific criteria that a transaction must meet to be considered substantially the same are discussed below.

12.27 For repos that are considered borrowings of securities, a liability should be established at the time of sale for the amount of the proceeds. The asset account should not be relieved of the collateral securities. Interest paid to the buyer-lender during the sale and repurchase period should be treated as interest expense. Also, the difference between the selling price and the repurchase price should be amortized to interest expense over the term of the agreement. Interest expense should not be offset against the interest income on the securities securing the borrowing.

12.28 For repos that are considered sales of securities, the asset including unamortized premium or discount should be credited, and a gain or loss should be recognized in income at the time of sale. If the market value of the securities sold differs from the contract price, the gain or loss should be recognized in income based on market value. The subsequent purchase of securities is recorded as a separate transaction when it occurs. If the debt instruments to be repurchased are the same or substantially the same as the ones sold, the agreement should be treated as a borrowing. However, if the debt instruments to be repurchased are not substantially the same as the ones sold, the agreement should be treated as a sale of securities and a commitment to buy other debt securities.

12.29 For debt instruments, including MBSs, to be substantially the same, all of the following criteria must be met:[6]

a. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, central

[6] These criteria are limited to transactions involving a sale and purchase or exchange of debt instruments between entities that hold the debt instruments as an asset. The term *debt instruments* is used in this chapter to include debt instruments considered to be securities such as notes, bonds, and debentures as well as other evidence of indebtedness such as mortgage loans and commercial loans, which are often not referred to as securities. Debt instruments also include evidence of indebtedness that represents aggregations of debt instruments, such as MBSs. These criteria are not intended to apply to situations in which an institution originates or buys whole loan mortgages and exchanges those loans for an MBS (issued by a government-sponsored enterprise) that represents direct ownership of the same mortgages. However, the criteria do apply to exchanges of participation certificates.

bank, government-sponsored enterprise or agency thereof, in which case the guarantor and terms of the guarantee must be the same.[7]

b. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder.[8]

c. The debt instruments must bear the identical contractual interest rate.

d. The debt instruments must have the same maturity, except for MBSs for which the mortgages collateralizing the securities must have similar remaining weighted-average maturities (WAMs) that result in approximately the same market yield. [9]

e. MBSs must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.

f. The debt instruments must have the same aggregate unpaid principal amounts, except for MBSs, where the aggregate principal amounts of the MBS given up and the MBS reacquired must be within the accepted good delivery standard for the type of MBS involved. [10]

12.30 ***Fixed-Coupon Agreements.*** Fixed-coupon dollar rolls generally should be accounted for as borrowings, as discussed above. Amortization of original premium or discount, and interest income on the original certificates, should continue to be recorded even if there is an exchange of certificates. However, a fixed-coupon agreement that contains a right-of-substitution clause or that provides an option to the buyer-lender to deliver back a certificate priced to result in a significantly different yield should be accounted for in the same manner as yield-maintenance agreements.

12.31 ***Yield-Maintenance Agreements.*** Yield-maintenance dollar rolls should be accounted for as sales with gain or loss recognition and commitments to purchase securities. If the market value of the securities sold differs from the contract price, the gain or loss should be recognized based on the market value. A sold certificate, including unamortized premium (discount), should be removed from the accounts and gains or losses recognized at the time of sale. The commitment to repurchase should be disclosed in the notes to the financial statements. The newly acquired security should be recorded at cost as a separate transaction at the time of purchase. Examples of accounting for yield-maintenance dollar agreements are included in appendix B to this Guide.

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[7] The exchange of pools of single-family loans would not meet this criterion, because the mortgages making up the pool do not have the same primary obligor and would therefore not be considered substantially the same.

[8] For example, the following exchanges would not meet this criterion: Government National Mortgage Association (Ginnie Mae) I securities for Ginnie Mae II securities; loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits (because such differences in the tax receipts associated with the loans result in instruments that vary "in form and type"); commercial paper for redeemable preferred stock.

[9] For example, the exchange of a *fast-pay* Ginnie Mae certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a *slow-pay* Ginnie Mae certificate would not meet this criterion, because differences in the expected remaining lives of the certificates result in different market yields.

[10] Participants in the MBS market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Public Securities Association (PSA) and can be found in *Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities*, which is published by the PSA.

12.32 ***Breakage.*** If the principal amount of the MBSs repurchased in a fixed-coupon dollar roll is greater than that of those originally sold, the difference should be recorded in the investment account as though a separate acquisition of additional MBSs has occurred. If the principal amount is less, the investment account should be relieved of the proportionate share of the MBSs that have been sold, and gains and losses adjusted for the pro rata share of unamortized premium or discount should be recognized.

12.33 ***Rollovers and Extensions.*** Rollovers and extensions of dollar rolls should be accounted for based on the facts and circumstances at the time of the rollover or extension. For example, the rollover at maturity of a fixed-coupon dollar roll into another fixed-coupon dollar roll that is substantially the same should be accounted for as a financing arrangement. However, when a fixed-coupon dollar roll is rolled over into another fixed-coupon dollar roll with the same coupon rate at a number of successive maturity dates, or when the period of time from initiation to close is lengthy (for example, more than one year), the transaction should be treated as a sale because the seller-borrower may not retain the risks and opportunities of ownership of a security that is substantially the same as the one sold. The rollover at maturity of a fixed-coupon dollar roll into a yield-maintenance dollar roll results in a new contract. The fixed-coupon agreement should be accounted for as the completion of a financing arrangement, and the rollover into a new yield-maintenance agreement should be accounted for as a sale with gain or loss recognition and a commitment to purchase securities.

12.34 ***Financial Statement Disclosures.*** Besides the disclosures required by FASB Statements of Financial Accounting Standards No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, and No. 107, *Disclosures about Fair Value of Financial Instruments*, the institution should disclose the following in the financial statements with respect to repos and reverse repos during the period—

a. The maximum amount of outstanding agreements at any month-end during the period.

b. The average amount of outstanding agreements for the period and the basis for averaging (that is, whether the amounts averaged were monthly or daily amounts).

c. A statement of whether the securities underlying the agreements were under the institution's control. [11]

Buyer-Lender's Transactions

12.35 The issues discussed above about whether a repo should be accounted for as a borrowing or sale of securities also apply to securities purchased under agreements to sell in determining whether the agreement should be accounted for as an actual purchase of securities or a financing. Fur-

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[11] *Control* refers to the ability of the institution to exercise legal authority over the securities that serve as the collateral for the repo in the event of default by the counterparty. The institution has a different loss exposure if it lacks control over the collateral when it sells securities under a repo than when it purchases securities under a repo. In the former agreement, the counterparty, for its benefit, usually exercises control over the securities underlying the agreement. The institution has a risk of exposure to the extent that its assets that serve as the collateral exceed the amount borrowed, including accrued interest.

ther disclosures should be made in the financial statements, or in the notes to the financial statements, similar to those for securities sold under agreements to repurchase.

Fair Value Disclosures

12.36 FASB Statement No. 107, as amended, requires disclosures of fair values of all financial instruments for which it is practicable to estimate fair value. The carrying amounts of repos and reverse repos maturing within 90 days generally would approximate their fair values. Under FASB Statement No. 107, quoted market prices should be used to estimate fair values. If quoted market prices are not available, quoted market prices and prevailing interest rates of financial instruments with similar characteristics should be used to estimate fair value.

Auditing

Objectives

12.37 The primary objectives of audit procedures applied to federal funds and repo transactions are to obtain reasonable assurance that—

a. The reported amounts include all federal funds purchased or sold and that repos and reverse repos are properly identified, described, and disclosed; include all such agreements; and are stated at appropriate amounts.

b. Interest expense or income and the related balance sheet accounts are properly measured and reported in the proper periods.

c. Repos and dollar rolls accounted for as borrowings meet the criteria for financings, that is, the securities to be repurchased are substantially the same as those sold.

d. Federal funds and repo transactions have been executed in accordance with management's authorizations and are obligations of the institution.

e. Assets pledged as collateral for federal funds and repo transactions are properly disclosed in the financial statements.

f. The federal funds sold and securities purchased under reverse repos exist and are either on hand or are held in safekeeping or custody for the bank.

g. The institution has legal title or similar rights of ownership for all recorded securities.

h. Recorded amounts include all such assets owned by the institution, and the financial statements include all related transactions during the period.

i. The values at which securities are reported are appropriate.

j. Realized and unrealized gains and losses on sales of securities are properly measured, recorded, and disclosed.

k. Securities involved in such agreements are properly described and classified in the financial statements and the related note disclosures are adequate.

Planning

12.38 Federal funds transactions are fairly routine for most institutions, are generally not complex, and many have matured by the close of audit fieldwork; thus, less risk may be associated with this account balance at a specific institution. Normal auditing procedures for borrowed funds should be applied to such obligations. However, certain repo transactions, whether viewed from an accounting, legal, or economic perspective, are extremely complex. Also, the risks involved in repo transactions vary widely, depending on the terms of the agreement, the parties involved, and the legal status of the agreement. The risks faced by an institution entering into a repo are generally reduced if the institution maintains effective internal control structure policies and procedures related to the authorization, processing, and recording of these transactions. The auditing guidance in this chapter focuses on repo transactions.[12]

12.39 The independent accountant should review the current year's interim financial statements, board of directors' reports and minutes, supervisory examination reports or related reports, and pertinent financial information and accounting to obtain an understanding of the level of activity in federal funds and repos, types of transactions entered into, accounting treatment (financing versus a sale and repurchase), and compliance with the institution's established investment and asset/liability management policies.

12.40 The independent accountant should be aware that when the institution concentrates its repos with one dealer or a small group of dealers, the evaluation of credit risk and counterparty risk assumes particular importance. The independent accountant should—

a. Consider the institution's controls over evaluating the reputation and financial strength of the dealer.

b. Review the latest audited financial statements of the dealer.

c. Determine the specific entity within an affiliated group with which the institution is doing business.

d. Be alert to the implications of transactions between that entity and its affiliates.

12.41 The audit procedures applied to federal funds purchased and securities sold under agreements to repurchase are also appropriate for federal funds sold and securities purchased under agreements to resell. However, the independent accountant should also be aware that as a buyer-lender an institution might not take delivery of the securities that serve as collateral in a repo transaction. If it does take delivery, either directly or indirectly through another party acting as its agent, credit risk is less than may otherwise be the case; the independent accountant should consider confirming the occurrence and terms of the transaction, and the seller-borrower's obligation to repurchase the securities with the seller-borrower, and should consider counting securities in the institution's possession and confirming securities not in its possession with the custodian.

12.42 Whenever a buyer-lender or its agent does not take delivery of the securities, the independent accountant should consider confirming not only the occurrence and terms of the transaction and the obligation to repurchase the

[12] In June 1985, a special task force of the Auditing Standards Board (ASB) issued a report on auditing repurchase agreements entitled *Report of the Special Task Force on Audits of Repurchase Securities Transactions*. The nonauthoritative report was the result of the task force's study of the adequacy of existing guidance on auditing transactions involving repo and reverse repo of securities. The report provides guidance with respect to accounting and reporting considerations, auditing considerations, and risk considerations.

securities but also that they have not been delivered and are being held on the institution's behalf. The independent accountant should also recognize that, when delivery is not made, the transaction has many of the attributes of an unsecured loan. Accordingly, the independent accountant should consider assessing the reputation and financial strength of the seller-borrower and of its custodian. Based on those assessments, the independent accountant should consider the desirability of obtaining a report from the custodian's independent accountant on the custodian's internal accounting controls over securities held in safekeeping, about which Statement on Auditing Standards (SAS) No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), provides guidance. The report should cover both the design of the system and compliance tests directed to specific objectives of internal accounting control over the custodial function.

Internal Control Structure Over Financial Reporting and Possible Tests of Controls[13]

12.43 The independent accountant should gain an understanding of the institution's internal control structure over financial reporting of federal funds and repo transactions. (Chapters 5 and 13 discuss related control issues for investments and borrowings, respectively.) Examples of internal control structure policies and procedures in this area are as follows:

- The institution has formal, written policies that specify the types of securities that can be sold or repurchased under repos.
- Formal policies and procedures are in place to provide that repo transactions are executed in accordance with written contracts that describe the rights and obligations of the parties. Master agreements used by the institution should be entered into by authorized personnel and should specify the terms of the transactions and the intent of the parties.
- Only board-approved securities dealers and other institutions are allowed to enter into transactions with the institution.
- The institution has policies and procedures to provide that only authorized individuals enter into and approve such transactions and that those individuals are aware of the inherent risks and returns of such agreements. The institution's board of directors sets limits on the amount and terms of agreements with particular securities dealers and other institutions.
- The institution has policies and procedures for monitoring the reputation, financial stability, and creditworthiness of securities dealers and other institutions with which the institution may enter into an

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[13] In December 1995, the ASB issued Statement on Auditing Standards (SAS) No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). SAS No. 78 revises the definition and description of internal control contained in the SASs to recognize the definition and description contained in *Internal Control—Integrated Framework* published by the Committee of Sponsoring Organizations of the Treadway Commission. SAS No. 78 is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted.

In conjunction with SAS No. 78, the ASB issued Statement on Standards for Attestation Engagements (SSAE) No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2* (AICPA, *Professional Standards*, vol. 1, AT sec. 400). SSAE No. 6 conforms the description of elements of an entity's internal control to the components of internal control contained in SAS No. 78 and the *Internal Control—Integrated Framework*. SSAE No. 6 is effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, with earlier application permitted.

agreement as a basis for evaluating their ability to fulfill their obligation to return the collateral to the institution.

- The institution has procedures for monitoring communications with securities dealers and other institutions and for reviewing confirmations from securities dealers to detect unrecorded or inappropriately recorded transactions and to determine the reasonableness of interest rates.
- Initial transactions and rollover agreements are reviewed by a responsible official who determines whether the transactions represent sales or financing transactions.
- Written policies require frequent evaluation of the market value, including accrued interest, of the agreements and required collateral levels.
- The subsidiary ledgers containing information on securities collateralizing agreements are periodically reconciled to the general ledger.
- Policies and procedures exist to monitor the use of hedging techniques, if any, to reduce market risk.

12.44 The independent accountant may perform tests of controls to obtain evidence of the effectiveness of policies and procedures and conclude that control risk is below the maximum. Examples of tests of controls the independent accountant may perform include the following:

- Obtain and review the institution's written investment and asset/liability management policies (or other applicable policies relating to the management of federal funds and repo transactions), and consider whether such policies have been reviewed and approved by the institution's board of directors.
- Obtain the institution's approved list of counterparties to agreements, and compare the list with those dealers with whom borrowing transactions were entered into during the current year. Ascertain that counterparty limits set by the board of directors have not been exceeded.
- Review selected transactions to consider whether all significant terms were specified and documented and whether the amounts and terms were consistent with those established by the institution's formal investment and asset/liability management policies.
- Review supporting documentation for transactions, and consider whether only authorized individuals entered into or otherwise executed those transactions on behalf of the institution.
- Test whether the institution has properly followed procedures for recording the difference between the selling price and repurchase price as interest expense and whether interest expense is properly recorded on other borrowings, such as federal funds purchased.[14]
- Review the latest audited financial statements of the counterparties and other available reports, such as reports on internal control structure or special-purpose reports by the dealer's accountant, to determine whether the dealer has net capital in excess of statutory requirements.[15]
- Review rollovers and extensions, and test whether within one year from the date of the initial transaction the institution properly funded the security, accepted delivery, closed out its position, and placed in its

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[14] These procedures also could be performed to provide substantive evidence.

[15] See footnote 12 in this chapter.

investment portfolio the security repurchased. For future dollar rolls using reacquired securities, test whether the securities were held in the institution's investment portfolio for sufficient time for the transaction to be accounted for as a financing.[16]

12.45 If there is reason to question the creditworthiness of the counterparty, the independent accountant should consider consulting with legal counsel regarding whether, in the event of the counterparty's inability to return (sell back) the collateral securities, the institution has the right to set off the loan liability against the collateral.

Substantive Tests

12.46 ***Inspection of Repo or Other Documentation of Borrowing.*** Repos and other source documents should be reviewed by the independent accountant and relevant details should be agreed to the respective recording of the liability in the subsidiary records. The independent accountant should test that securities collateralizing the borrowing are adequately identified to ensure proper disclosure, and the amounts and description should be agreed to the respective subsidiary ledger.

12.47 ***Confirmation.*** The independent accountant should consider confirming the amount and all significant terms of federal funds and repos with the respective securities dealers, customers, and institutions. Details of any rollovers or extensions of repos should be agreed to brokers' advices. Confirming the repo transactions provides evidence of the occurrence of the transactions, their terms, and the treatment of the underlying securities, for example, evidence that the securities were delivered to the counterparty; confirmation does not provide evidence about the existence, location, or transferability of the securities or about the counterparty's ability to complete the transactions. It is usually impracticable to confirm the location of the securities delivered to the counterparty as collateral. The counterparty often is not able to determine the exact location of the securities delivered because they are fungible with other securities of the same issue under the dealer's control and are commingled with those securities. In addition, the counterparty may have appropriately used the securities for collateral in another repo or dollar roll in which the counterparty sold the securities to be repurchased at a later date. The seller-borrower and its independent accountant need not necessarily be concerned, however, about the location of securities transferred to the counterparty as collateral because their location does not necessarily affect the risk that the counterparty may not complete the transactions.

12.48 The independent accountant should consider the need to assess the counterparty's ability to complete the transaction by other procedures, such as testing subsequent completion of the transaction, reviewing audited financial statements of the counterparty, considering the regulatory requirements applicable to the counterparty, and, if necessary, obtaining a special-purpose report from the counterparty's independent accountant.

12.49 ***Review of Related Party Transactions.*** The independent accountant should consider reviewing borrowing transactions involving related parties that have been accounted for as sales transactions to determine whether there are potential unrecorded financing transactions. A review of transaction activity may indicate that an event accounted for as two separate

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[16] See footnote 12 in this chapter.

transactions—a sale and subsequent purchase—is in fact a repo that should be accounted for as a financing. The independent accountant should be alert for related party transactions that are improperly accounted for, possibly to avoid recognizing losses on sales.

12.50 ***Assess Collateral Risk.*** The independent accountant should assess the collateral risk through consideration of the counterparty's reputation, financial position, and market presence. The independent accountant should review the current market values, including accrued interest, of securities serving as collateral and consider whether the collateral is sufficient or excessive in relation to the requirements of the agreement. Further, the independent accountant should assess whether those securities repurchased under repos meet the substantially-the-same criteria for financing transactions or whether a gain or loss should have been recorded under a sales transaction.

12.51 ***Analytical Procedures.*** Chapters 5 and 13 discuss analytical procedures that may also be applied in this area.

12.52 ***Tests of Fair Value Disclosures.*** The independent accountant should test the institution's fair value disclosures by referring to the quoted market prices or prevailing interest rates of the same or similar instruments to evaluate whether the estimates are reasonable. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance on evaluating accounting estimates.

12.53 ***Other Procedures.*** Other audit procedures related to repos that the independent accountant may consider performing are as follows:

- Read the board of directors' minutes to determine whether financing transactions have been authorized.
- Test whether approved securities dealers are used, and whether financing arrangements comply with the institution's established policies.
- Recompute gains or losses on reverse repos that are not accounted for as financing agreements on a test basis.

12.54 The independent accountant should be aware that when the institution concentrates its repos with one counterparty or a small group of counterparties, the evaluation of credit risk assumes particular importance. The independent accountant should consider the institution's controls over evaluating the reputation and financial strength of the counterparty. The independent accountant should also review the latest audited financial statements of the counterparty. The independent accountant should determine the specific entity within an affiliated group with which the institution is doing business, and should be alert to the implications of transactions between that entity and its affiliates.

Chapter 13
Debt

Introduction

13.01 Banks and savings institutions use long- and short-term borrowings to provide funds that supplement deposits and to carry out their overall asset/liability management strategy.

Long-Term Debt

13.02 The most common long-term debt funding sources are debentures and notes. Institutions also may have long-term mortgages, obligations and commitments under capital leases, and mandatorily redeemable preferred stock, which have many of the characteristics of debt. Such obligations are similar to those of other kinds of enterprises. Funds are also borrowed through Eurodollar certificates, collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs), mortgage-backed bonds (MBBs), mortgage-revenue bonds, and Federal Home Loan Bank (FHLB) advances.

13.03 The terms of an institution's long-term debt obligations vary widely. They may be secured or unsecured; unsecured is far more prevalent. The debt may be senior or subordinated to other debt. The debt may be convertible into shares of common stock. Convertible debentures are convertible into stock at a specified price at the option of the holder. In most cases, convertible debt securities are also callable at the option of the issuer, generally beginning a few years after issuance. Interest rates may be fixed or floating.

13.04 Institutions and their subsidiaries sometimes finance expansion using traditional real estate mortgages.

Short-Term Debt

13.05 ***Repurchase Agreements (Repos).*** Repos are discussed in chapter 12.

13.06 ***Federal Funds Purchased.*** Federal funds purchased are discussed in chapter 12.

13.07 ***Commercial Paper.*** Commercial paper is an unsecured promissory note that provides creditworthy institutions (typically, bank or savings institution holding companies) with short-term funds. Commercial paper is generally short-term (at most 270 days, but usually much less) and negotiable.

13.08 ***Borrowing From Federal Reserve Discount Windows and FHLBS.*** Member institutions may borrow from their regional Federal Reserve Bank in the form of discounts (often called *rediscounts*) and advances, which are primarily used to cover shortages in the required reserve account and also in times of liquidity problems. Most institutions regard the discount window as a lender of last resort. A discounting transaction is technically a note to the Federal Reserve with recourse secured by a member institution's eligible loans. In an advancing transaction, a member institution executes a promissory note, which is collateralized generally by government securities to the Federal Reserve. Most discount-window transactions are in the form of advances. Interest charged in those transactions is referred to as *discount*. The rates are set biweekly by the individual reserve banks. Such loans usually have short maturities. Members of the FHLB System (FHLBS) can obtain advances of varying maturities from their district FHLBs. FHLB advances often are secured through pledges of loans or securities.

13.09 ***Treasury Tax and Loan Note Accounts.*** Employers that withhold federal taxes from employees' pay are required to deposit those funds periodically with a bank or savings institution. Institutions record such deposits, which are non-interest-bearing, as treasury tax and loan accounts (TT&L accounts) and include such accounts with their deposits. However, on the day after receipt such funds must be remitted to the Federal Reserve Bank or converted into an open-ended, interest-bearing note, commonly referred to as a *treasury tax and loan note account.*

13.10 ***Bankers' Acceptances.*** A banker's acceptance, which is often used to finance shipments of goods to bank customers, is a short-term time draft that a bank (drawee) has agreed to pay at maturity by stamping "accepted" over the signature of an officer. When the bank accepts the draft, it guarantees its redemption at maturity, which makes the draft negotiable. In return for the guarantee, the party on whose behalf the bank accepts the draft (drawer) agrees to provide the bank with the necessary funds prior to maturity. The bank receives a fee for creating the acceptance. The drawer's outstanding debt to the bank is reported as an asset, and the bank's obligation is reported as a liability. Bankers' acceptances are similar to other short-term borrowed funds in that they can be effectively used for short-term liquidity needs by avoiding disbursing funds for short-term loans to bank customers.

13.11 ***MBBs.*** MBBs are any borrowings (other than those from an FHLB) collateralized in whole or in part by one or more real estate loans. MBBs typically have the following characteristics:

a. Fixed maturities or payments of principal and interest

b. The use as collateral of mortgage loans or mortgage-backed securities (MBSs) owned by the issuer

c. Stated or fixed interest rates with interest payable monthly or semiannually (there may also be call provisions)

d. Principal payments made through periodic sinking-fund payments or at final maturity

e. Mortgage collateral in which the purchaser does not have an ownership interest

f. Collateral values usually ranging from 110 percent to 200 percent of the amount of the debt issue, so that the collateral exceeds the principal value during its entire outstanding life (overcollateralization)

13.12 The total mortgage collateral pool is generally overcollateralized to the extent necessary to provide assurance that the investor can sell the mortgage loans without loss in the secondary market should the MBB issuer default.

13.13 ***Preferred Stock and Other Obligations of Finance Subsidiaries.*** Finance subsidiaries, as defined in federal regulations, are a means by which institutions can issue preferred stock and other securities at rates lower than those the institutions would otherwise have to pay if they issued the securities directly. Thus, finance subsidiaries afford institutions the opportunity to obtain less costly funds.

13.14 In a structured financing (the simplest form of a finance subsidiary), the parent institution transfers certain assets to a special-purpose finance subsidiary to collateralize or otherwise support the securities issued by the finance subsidiary. In return for the assets, the subsidiary remits the net proceeds of the offering to the parent for use in operations. Where debt is issued at the subsidiary level, the trustee for the debt perfects a security interest in the transferred collateral. If preferred stock is issued, no security interest is perfected. However, because the finance subsidiary is chartered for the limited purpose of issuing the securities and can neither incur debt nor engage in any other business, the preferred stock is, in fact, insulated from other encumbrances and is, therefore, backed by the collateral in a manner approximating a security interest. The result is to provide greater protection for preferred stockholders than any of them would have had if the parent institution had been the issuer.

13.15 The economic value of this financing technique is made possible by a variety of factors. Because of the requirements established by the rating agencies, preferred stock offerings are significantly overcollateralized by a combination of mortgage securities, short-term money-market instruments, treasuries, and other securities. This degree of collateralization, combined with the protection afforded by the structure, enables the rating agencies to issue triple-A ratings. Additionally, because qualified corporate taxpayers holding preferred stock are eligible for a deduction of a specified percentage of dividends received, the dividends paid by the issuer can be low by market standards, making the transaction a low-cost "borrowing" for the parent.

13.16 ***CMOs.*** As introduced in paragraph 5.25, CMOs are multiclass, pay-through bonds collateralized by MBSs or mortgage loans and are generally structured so that all, or substantially all, of the collections of principal and interest from the underlying collateral are paid to the holders of the bonds. Typically, the bonds are issued with two or more maturity classes; the actual maturity of each bond class varies depending upon the timing of the cash receipts from the underlying collateral. CMOs are usually issued by a minimally capitalized special-purpose corporation (issuer) established by one or more sponsors (that is, the original owners of the mortgages). The MBSs collateralizing the obligations are acquired by the special-purpose corporation and then pledged to an independent trustee until the issuer's obligation under the bond indenture has been fully satisfied. The investor agrees to look solely to those trusteed assets and the issuer's initial capital (collectively referred to as *segregated assets*) for repayment of the obligations. Therefore, the sponsor and its other affiliates no longer have any financial obligations for the instrument, although one of those entities may retain the responsibility for servicing the underlying mortgage loans.

13.17 For the sponsor of the CMO, cash is immediately generated; there is no waiting for collection of the amounts when the respective mortgage payments come due. Credit enhancement of CMOs is generally achieved by using collateral that carries a third-party guarantee; otherwise, they are overcollateralized to mitigate the risk of default. The excess collateral reverts to the sponsor at the maturity of the CMOs. The sponsor of the CMO issuer may retain any residual (see chapter 5) or an unrelated third party may acquire the residual as an investment.

13.18 For both the issuer and investor, cash flows may not materialize as scheduled. For example, prepayments of the underlying mortgages at a greater-than-anticipated rate can reduce the yield to maturity expected by the investor.

13.19 ***REMICs***. REMICs are vehicles for issuing multiclass mortgage-backed obligations that require compliance with a number of technical requirements of the Internal Revenue Code (IRC). REMIC refers to the taxable entity (rather than to the security structure like a CMO and other types of mortgage-backed borrowings). Failure to comply with the requirements could result in imposition of a corporate income tax on the gross income of the REMIC. REMIC certificates of ownership are qualifying real property loans and qualified assets under the IRC.

13.20 To qualify for REMIC status as defined by the IRC, all of the assets continuously held by the REMIC must consist of qualified mortgages and permitted investments. In general, the term *qualified mortgages* refers to mortgages that are principally collateralized by an interest in real property and are transferred to the REMIC at the time of its formation or purchased by the REMIC within three months of its formation. Qualified mortgage also refers to a regular interest in another REMIC. The term *permitted investments* includes cash flow investments, qualified reserve assets, and foreclosed property.

13.21 All of the interests in the REMIC must consist of either regular interests or residual interests. A regular interest is an interest that unconditionally entitles the holder to receive specified principal and interest payments under terms that are fixed at the time of the REMIC's formation. A residual interest is any interest in a REMIC that is not a regular interest. Only one class of residual interest may exist with respect to a REMIC. In other words, the rights of all of the holders of interests that do not qualify as regular interests must be exactly the same.

Regulatory Matters

13.22 Institutions regulated by the Office of Thrift Supervision (OTS) must notify the OTS before borrowing money, unless the institution meets regulatory capital requirements and any applicable minimum capital directive. Regulations may also prohibit growth above a certain level without prior regulatory approval. Further, savings institutions must obtain written approval (prior to issuance) for subordinated debt to qualify as regulatory capital.

13.23 Banks must include notification of any planned rapid growth (as defined) in filing of regulatory financial reports.

13.24 The OTS does not permit preferred stock issued by a finance subsidiary to be treated as regulatory capital at the parent level. Federal regulations specify certain requirements for investments in finance subsidiaries.

13.25 Section 142 of the Federal Deposit Insurance Corporation (FDIC) Improvement Act of 1991 (FDICIA) limits the availability of borrowings through the Federal Reserve discount window for certain borrowings.

13.26 The OTS follows generally accepted accounting principles (GAAP) as established by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 76, *Extinguishment of Debt.* The other agencies require banks to continue to report defeased debt as a liability and to record any funds placed in trust as assets—without netting.

Accounting and Financial Reporting[1]

13.27 Significant categories of borrowings should be presented as separate line items in the liability section of the balance sheet. The notes to the financial statements should describe the principal terms of the respective agreements including, but not limited to, the title or nature of the agreement, or both; the interest rate (and whether it is fixed or floats); the payment terms and maturity date(s); collateral; conversion or redemption features; whether it is senior or subordinated; and restrictive covenants (such as dividend restrictions), if any. The notes should also describe maturities and sinking-fund requirements for each of the next five years. If debt is considered in-substance defeased, a general description of the transaction and the amount of the debt that is considered extinguished at the end of the period must be disclosed as long as the debt remains outstanding.

Long-Term Debt

13.28 Accounting for long-term obligations is the same for banks and savings institutions as for other enterprises. However, because banks and savings institutions have unclassified balance sheets, there is no need to separate balances into current and long-term portions. Costs related to the issuance of debentures or other debt should be deferred and amortized to interest expense using the effective interest method over the life of the issue. For redeemable preferred stock of a subsidiary accounted for as liabilities, dividends should be included in the determination of income. For redeemable preferred stock treated as capital, but displayed in the balance sheet as mezzanine capital, dividends should be included in the statement of changes in shareholders' equity.

13.29 ***Bankers' Acceptances.*** In Issue No. 85-34, *Banker's Acceptances and Risk Participations*, the FASB's Emerging Issues Task Force (EITF) agreed that a sale or conveyance of a risk participation of a bankers' acceptance should not be treated as an extinguishment of the obligation under the acceptance.

13.30 ***MBBs.*** MBBs are debt obligations of the issuing institution and should be classified as debt on the institution's balance sheet. They should be separately classified from advances, other notes payable, and subordinated debt. Any discounts or premiums associated with the issuance of MBBs should be recorded in a contra liability (debit) or liability (credit) account. Bond issue costs or expenses (legal, accounting, printing, and other expenses) should be deferred and amortized to operations using the constant effective yield method over the life of the bonds.

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[1] In October 1995, the FASB issued a proposed Statement, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The proposed Statement would significantly affect accounting for (including disclosures about) securitizations, sales of partial interests, servicing assets and liabilities, securities lending transactions, repurchase agreements, "wash sales," loan syndications and participations, risk participations in banker's acceptances, factoring arrangements, and transfers of receivables with recourse.

Comments on the proposed Statement were due in January 1996. Readers should be alert to any final pronouncement.

13.31 Institutions may wish to extinguish debt through early redemption. Even when a debtor is unable to redeem the debt because of call or prepayment protection in the debt agreement, the debtor may extinguish the debt through an in-substance defeasance transaction. Under such a transaction, the debtor buys securities with cash flows (principal and interest) matching those of the outstanding debt, and restricts those cash flows to servicing and retiring the debt. FASB Statement No. 76 provides criteria for determining whether debt has been extinguished. Gains and losses from extinguishment of debt should be included in the determination of net income and, if material in the aggregate, classified as an extraordinary item, net of related income tax effect, in accordance with FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt.*

13.32 In accordance with FASB Statement No. 47, *Disclosure of Long-Term Obligations*, institutions should disclose maturity and sinking-fund requirements for each of the five years following the last balance-sheet date. Further, if debt is considered in-substance defeased, a general description of the transaction and the amount of the debt that is considered extinguished at the end of the period should be disclosed as long as the debt remains outstanding. Assets pledged as collateral for long-term obligations should be disclosed in the financial statements.

13.33 Institutions generally separately disclose debt that is treated as Tier II or supplementary capital for regulatory capital purposes.

13.34 ***Foreign Currency Debt.*** EITF Issue No. 86-25, *Offsetting Foreign Currency Swaps*, addresses how the effect of a change in exchange rates on a foreign currency swap contract should be displayed in the balance sheet.

13.35 ***Dual Currency Bonds.*** EITF Issue No. 93-10, *Accounting for Dual Currency Bonds*, addresses accounting for the effect of a change in foreign currency rates on dual currency bonds.

Short-Term Debt

13.36 ***Preferred Stock and Other Obligations of Finance Subsidiaries.*** The preferred stock of finance subsidiaries is generally classified as a liability or minority interest in consolidated financial statements. Dividends on the preferred stock of finance subsidiaries are included in the determination of net income.

13.37 ***REMICs.*** Institutions may enter into REMIC transactions to raise immediate cash from mortgage agreements. In addition, some institutions use MBSs with unrealized losses as the underlying collateral for the REMIC issue. Those institutions generally classify the transaction as a financing for financial reporting purposes (as long as the requirements of FASB Technical Bulletin No. 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs),* are met) and as a sale for federal income tax purposes to record the losses and thus obtain a current tax deduction.

13.38 As discussed earlier, REMIC is simply a label that covers various forms of underlying securities. These securities may resemble either CMOs or pass-through certificates that represent a sale of the underlying receivables. The legal form of the transaction determines whether the transaction should be accounted for under FASB Statement No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*, or Technical Bulletin 85-2. That is, a REMIC that purports to be a sale is subject to the requirements of FASB Statement No. 77. A REMIC documented as a collateralized mortgage obligation is subject to the requirements of Technical Bulletin 85-2.

13.39 For federal income tax purposes, REMIC transactions can be considered sale transactions. In general, when qualified mortgages are transferred to the REMIC in exchange for the regular and residual interests in the REMIC, no gain or loss is recognized for federal income tax purposes. Instead, the transfer of the mortgages and the issuance of the REMIC interests are treated as a carryover-basis transaction. Upon the sale of any of the interests that are received from the REMIC, a taxable gain or loss is recognized. The amount of the taxable gain or loss is equal to the fair market value of the consideration received for the interest less the adjusted basis of the interest at the time of sale.

13.40 ***CMOs.*** FASB Technical Bulletin No. 85-2 provides guidance on accounting for CMOs. CMOs should be presumed to be borrowings and reported as liabilities in the financial statements of the issuer unless all but a nominal portion of the future economic benefits of the associated collateral have irrevocably passed to the investor and no affiliate of the issuer can be required to make future payments with respect to the obligation. However, if all of the following conditions exist, the transaction is no longer considered a borrowing, the associated collateral should no longer be recorded on the issuer's financial statements, and gain or loss should be recognized.

a. The issuer and its affiliates surrender control of the future economic benefits embodied in the collateral securing the obligation.

   (1) Neither the issuer nor its affiliates have the right or obligation to substitute collateral or obtain it by calling the obligation.

   (2) The expected residual interest in the collateral, if any, is nominal.

b. No affiliate of the issuer is required to make any future payments with respect to the obligation.

   (1) The investor agrees to look solely to the issuer's segregated assets or third parties (such as investors or guarantors) for repayment of the obligation, and neither the sponsor of the issuer nor its other affiliates are secondarily liable.

   (2) Neither the issuer nor its affiliates can be required to redeem the obligation prior to its stated maturity other than through the normal pay-through of collections from the collateral.

13.41 If all of the above conditions are met, and the associated collateral is eliminated from the financial statements, any expected residual interest in the collateral should not be recognized as an asset. Rather, such residual interest should be recorded as it accrues to the benefit of the issuer or its affiliates.

13.42 If servicing rights are retained by an affiliate of the issuer, and the stated servicing fee rate is less than a current (normal) servicing fee rate, the CMO proceeds and resulting gain or loss should be adjusted to provide for a normal servicing fee in each subsequent servicing period (see chapter 8).

13.43 All transaction costs associated with an offering accounted for as a sale should be expensed when the associated collateral is eliminated from the financial statements and the resultant gain or loss is recognized.

13.44 EITF Issue No. 84-30, *Sales of Loans to Special-Purpose Entities,* addresses whether the consolidated financial statements of an institution should include the assets and liabilities of a special-purpose corporation.

Lease Financing

13.45 Accounting for leases by lessees and lessors is established by FASB Statement No. 13, *Accounting for Leases,* as amended by FASB Statement No. 98, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, Initial Direct Costs of Direct Financing Leases.* Other interpretive pronouncements address additional circumstances.

Lending of Customers' Securities

13.46 Banks and savings institutions sometimes lend customers' securities. Any contingencies related to the lending of securities should be accounted for in conformity with FASB Statement No. 5, *Accounting for Contingencies.*

Fair Value Disclosures

13.47 FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments,* as amended, requires disclosures of fair values of all financial instruments for which it is practicable to estimate fair value. Paragraph 28 of FASB Statement No. 107 says that "a fair value for financial liabilities for which quoted market prices are not available can generally be estimated using the same techniques used for estimating the value of financial assets" and provides further guidance.

Auditing

Objectives

13.48 The primary audit objectives in this area are to obtain reasonable assurance that—

a. Short- and long-term borrowings recorded as of the date of the financial statements include all such liabilities of the institution and that they have been properly valued, classified, described, and disclosed and reflect all transactions for the period.

b. Financing subsidiaries are consolidated with the parent institution as required by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries.*

c. Interest expense and the related balance-sheet accounts (accrued interest payable, unamortized premiums or discounts, and issuance costs) are properly measured and recorded, and amortization has been properly computed.

d. Transactions representing an extinguishment of debt through an in-substance defeasance are properly evaluated and reported, and any related gains or losses on the transactions are properly calculated and reported.

e. Collateral for borrowings is properly identified and disclosed.

f. Borrowings have been authorized in accordance with management's written policies and are obligations of the institution.

g. The effects on reported amounts and disclosures of any noncompliance with debt covenants are properly identified, described, and disclosed.

Planning

13.49 In planning the audit, the independent accountant should consider the factors influencing inherent risk as it relates to other borrowings. Such factors might include regulatory considerations, the existence of restrictive covenants, and the existence and adequacy of collateral, if applicable. The independent accountant should also review board of directors' reports, the current year's interim financial statements, and other documents that may include information about whether any significant new debt has been incurred or issued and whether any significant debt has been repaid or refinanced. The independent accountant should also inquire as to the existence of financing subsidiaries.

Internal Control Structure Over Financial Reporting and Possible Tests of Controls[2]

13.50 Internal control structure policies and procedures relating to the financial reporting of debt include the following:

- Debt transactions are reviewed and approved by the board of directors or its designated committee and documented in the minutes.
- Debt agreements are reviewed by the appropriate accounting and legal personnel to ensure that borrowings meet GAAP criteria for classification as a liability.
- Adjustments to liability accounts are reviewed and approved by a responsible official.
- The institution is named as issuer or borrower in the respective credit or financing agreements.
- All off-balance-sheet obligations (such as operating leases and guarantees) have been identified, described, and disclosed.
- The subsidiary ledgers for long- and short-term borrowings and collateral are periodically reconciled with the general ledger.
- Reports or statements from outside trustees or transfer agents are periodically reconciled to the institution's records.
- Through periodic confirmation with the trustee or transfer agent, the institution ascertains that collateral on borrowings remains sufficient.

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[2] In December 1995, the Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). SAS No. 78 revises the definition and description of internal control contained in the SASs to recognize the definition and description contained in *Internal Control—Integrated Framework* published by the Committee of Sponsoring Organizations of the Treadway Commission. SAS No. 78 is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted.

In conjunction with SAS No. 78, the ASB issued Statement on Standards for Attestation Engagements (SSAE) No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2* (AICPA, *Professional Standards*, vol. 1, AT sec. 400). SSAE No. 6 conforms the description of elements of an entity's internal control to the components of internal control contained in SAS No. 78 and the *Internal Control—Integrated Framework*. SSAE No. 6 is effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, with earlier application permitted.

- Borrowings (such as CMOs and REMICs) are reviewed to ensure that they meet the GAAP criteria for treatment as financing transactions.
- If defeasance of debt has occurred, documentary evidence of defeasance of debt and related documentation of compliance with the requirements of FASB Statement No. 76 have been maintained.
- Periodic tests of covenant compliance are performed and reviewed by responsible personnel.

13.51 It is often more efficient and effective to assess control risk at the maximum for debt and take a primarily substantive approach. However, certain tests of controls, such as those over interest accruals and recurring cash payments, may provide audit evidence more efficiently than a purely substantive approach. The independent accountant should obtain an understanding of relevant internal control structure policies and procedures to plan effective substantive tests.

13.52 SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), paragraphs 6 through 21 provide guidance on the user auditor's consideration of the effect of a service organization on the internal control structure of the user organization and availability of audit evidence. That guidance should be considered when planning and performing the audit of the financial statements of an institution that uses a service organization to process transactions (for example, processing CMO or REMIC cash flows by a trustee).

Substantive Tests

13.53 ***Review of Documentation.*** The independent accountant should review documentation such as legal agreements and notes supporting long-term debt and agree pertinent information to subsidiary ledgers. The independent accountant should review the following information:

a. Type of debt

b. Interest rate and dates interest is payable

c. Maturity of the debt

d. Underlying collateral of the debt, if any

e. Subordination of the debt

f. Evidence of regulatory approval, if required

g. Presence of restrictive covenants

13.54 ***Confirmation.*** The independent accountant should consider confirming pertinent information with the trustee or transfer agent, including all terms, unpaid balance, accrued interest payable, principal and interest payments made during the year, collateral description, annual trust accounts activity, and the occurrence of any violations of the terms of the agreement. If collateral is not under the control of the institution and is held by a trustee or transfer agent, the independent accountant should confirm its existence, completeness, and valuation with the trustee or transfer agent. If collateral is deemed deficient with respect to the terms of the debt agreement or is not under the control of the institution, the independent accountant should consider the need for disclosure.

13.55 ***Tests of Valuation.*** The independent accountant should test borrowings that were issued at a premium or discount to determine whether amortization has been properly computed and recorded. The independent accountant should also evaluate the propriety of amortization of costs incurred in connection with a debt issuance. The independent accountant should assess the sufficiency of the value of assets collateralizing any borrowings by confirmation.

13.56 ***Analytical Procedures.*** Analytical review procedures can provide substantive evidence about the completeness of debt-related financial statement amounts and disclosures; however, such procedures in tests of debt expense are often less precise than substantive tests such as recalculations. Because institutions generally issue a wide variety of debt with rates that vary with each issuance, it is normally difficult to develop expectations to be used in analyzing yields on debt. Accordingly, analytical procedures in this area should generally be considered only as a supplement to other substantive tests. Further guidance is provided in SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), and SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326). The independent accountant should be careful not to view trends entirely from a historical perspective; current environmental and business factors as well as local, regional, and national trends should be considered to determine if the institution's trend appears reasonable. Following are some of the analytical review procedures that should be considered.

- Compare interest expense by major category of debt as a percentage of the average amount of the respective debt outstanding during the year with stated rates on the debt instruments (yield test).
- Evaluate the reasonableness of balance-sheet accruals and other related balance-sheet accounts (accrued interest payable, deferred issuance costs, and premiums and discounts) by comparison to prior-year balances.

13.57 ***Other Procedures.*** Other audit procedures related to debt and the extinguishment of debt are as follows:

- Review debt covenants and test whether the institution has complied with such covenants. Determine whether disclosures are appropriate.
- If the institution has assets from which the cash flows will be used to service a specific obligation of the institution, test whether the transaction(s) represents the extinguishment of debt through an in-substance defeasance transaction and whether it has been properly recorded.
- If there has been an in-substance defeasance of debt, review legal documents, including trustee agreements, to test that defeasance meets irrevocability requirements; review assets acquired to extinguish debt and evaluate the cash flows provided by those assets relative to cash flows required by the defeased debt; and review the computation of the gain or loss on defeasance, including the calculation of the present value of defeased debt.
- Read minutes of meetings of the board of directors to determine whether financing transactions have been authorized in accordance with the institution's written policies.
- Compare recorded interest expense and accrued interest payable to recorded debt for completeness of debt liabilities.
- Obtain a detailed supporting schedule of prior-year and current-year account balances. Agree the prior-year balance to prior-year working

papers and the current-year balance to the general ledger. Review activity for reasonableness.

- For CMOs and REMICs, consider whether all economic benefits associated with the collateral have been irrevocably passed to the investor (as defined by FASB Technical Bulletin No. 85-2). If all economic benefits have been irrevocably passed to the investor, test whether the transaction has been accounted for as a sale and repurchase. If it is determined that all economic benefits have not been passed to the investor, test whether the transaction has been accounted for as a financing.
- For CMOs and REMICs, obtain and review compliance and verification letters prepared by the trustee's independent accountants. (Such letters are prepared on an annual basis and provide for the verification of the principal balance of the collateral and bonds, the cash flows associated with the issue, and compliance with the respective terms of the underlying agreements.)
- Examine canceled notes for borrowings that have been paid in full.
- Read lease agreements, identifying those that should be capitalized, and determine whether they were recorded using effective rates of interest.

13.58 If applicable, the independent accountant may be engaged to perform agreed-upon procedures relating to collateral for FHLB advances by reference to the security agreement signed by the institution's management that indicates compliance. The procedures depend upon the nature of the agreement (blanket lien, specific lien without delivery, or specific lien with delivery of the collateral). The respective district FHLB should provide guidance on procedures to be performed.

Chapter 14

Income Taxes

Introduction

14.01 Banks and savings institutions generally are subject to the same tax rules that apply to other corporations, including those that are members of a consolidated group. The Internal Revenue Code (IRC), however, contains many provisions specific to banks, savings institutions, or both. The purpose of this chapter is to highlight certain federal tax matters and related accounting matters specific to the industry and to provide related auditing guidance.[1]

Banks

14.02 ***Definition of a Bank for Tax Purposes.*** IRC Section 581 defines a bank for tax purposes and provides special rules governing bank taxation.

14.03 ***Securities Gains and Losses.*** IRC Section 582 provides banks special treatment for certain asset dispositions. Gains and losses on bonds, debentures, notes, certificates, and other evidences of indebtedness held by banks generally are treated under IRC Section 582 as ordinary (rather than capital) gains and losses. Equity securities and other investments generally are not afforded IRC Section 582 ordinary treatment. IRC Section 582 generally is not applicable to nonbank subsidiaries, including, for example, passive investment companies established for state planning purposes.

14.04 ***Mark to Market.*** IRC Section 475 generally requires any company that is a dealer in securities to mark its securities to market. A dealer is broadly defined as any taxpayer that regularly purchases securities from, or sells securities to, customers in the ordinary course of business. The definition of securities differs from and is generally more expansive than the definition of securities in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. For purposes of IRC Section 475 nonsecuritized loans are, in some circumstances, considered securities. Further, institutions generally may not exempt any security held for investment if it is identified as such at the date of acquisition. A window (sometimes as much as 30 days) has generally been allowed for identification of certain loans.

14.05 ***Tax Bad Debt Deductions.*** IRC Section 585 provides that a bank with $500 million or less in assets is allowed a tax bad debt deduction for reasonable additions to the bad debt reserve. This asset test generally is based upon the average adjusted tax basis of all assets. If the institution is a member of a controlled group (as defined), all assets of the group are taken into account. The annual addition to the reserve generally cannot exceed the greater of the amount computed using actual experience percentages or the base year fill-up method (as defined).

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[1] This chapter is not intended to provide comprehensive discussion of all possible tax matters an accountant might encounter in the preparation or audit of the financial statements of a bank or savings institution. Further, state tax matters are beyond the scope of the introductory section of this chapter. Consulting this chapter cannot take the place of a careful reading of the related laws, regulations, rulings, and related documents, where appropriate.

14.06 A bank with assets exceeding $500 million generally is allowed to claim a tax bad debt deduction only under the general rule of IRC Section 166, which generally permits taxpayers to deduct any debt that becomes worthless, in whole or in part, during the taxable year (the *specific charge-off* method).

14.07 ***Foreclosed Property, Other Real Estate Owned***. Generally, once a property has been foreclosed and the gain or loss on foreclosure has been recognized, a bank is allowed no further valuation deduction or impairment write-down. Any post-foreclosure reduction in value generally is suspended until the property is ultimately disposed. Special rules under IRC Section 595 apply to qualified savings institutions.

14.08 ***Net Operating Losses (NOLs)***. For taxable years beginning in 1994, net operating losses (NOLs) of banks and savings institutions generally are carried back three years and then forward fifteen years under the provisions of IRC Section 172. For taxable years prior to 1994, banks and savings institutions had various special provisions in the IRC that determined the appropriate carryback and carryforward periods.

14.09 ***Interest Expense Relating to Tax-Exempt Income***. IRC Section 291 generally provides that 20 percent of the allocable interest expense attributable to tax-exempt obligations acquired by a financial institution after 1982 and before August 8, 1986, is not deductible. For tax-exempt obligations acquired after August 7, 1986, IRC Section 265 generally requires that all of the interest expense attributable to the obligation be nondeductible. An exception exists for certain "qualified small issuer" obligations (as defined), which are subject to IRC Section 291.

14.10 ***Alternative Minimum Tax (AMT)***. Beginning in 1987, corporations generally must compute their federal tax liability under both the regular tax and alternative minimum tax (AMT) systems and pay the higher amount. The AMT system is a separate but parallel tax system in which regular taxable income is increased or decreased by certain AMT adjustments and preference items to arrive at AMT income. A rate of tax generally lower than the regular tax rate is applied to AMT income. The AMT adjustments and preference items most common for banks include tax-exempt interest income on private activity bonds issued after August 7, 1986 (reduced by any related interest expense disallowance), accelerated depreciation and cost recovery, and bad debt reserve additions for certain savings institutions (IRC Section 593). Further, only 90 percent of AMT income may be offset by a NOL. Any excess of tax computed under the AMT system over the regular system generally is eligible to reduce future regular tax (a *minimum tax credit*).

Savings Institutions

14.11 As for banks, the IRC includes provisions applicable only to savings institutions. These provisions relate primarily to calculation of bad debt deductions, transactions in foreclosed real estate, and deductibility of interest on deposits. For these provisions to apply, however, an institution generally must meet the definition of a *savings institution* under the IRC.

14.12 ***Definition of a Savings Institution for Tax Purposes***. The discussion that follows relates to savings institutions considered to be mutual savings banks (IRC Section 591), domestic building and loan associations (IRC Section 7701(a)(19)), or cooperative banks (IRC Section 7701(a)(32)).

14.13 *Mutual savings bank* is not defined in the tax law, but IRC Section 591(b) says the term includes any bank with capital stock represented by shares that is subject to, and operates under, federal or state laws relating to mutual savings banks. Such mutual savings banks generally must meet only the 60 percent asset test (see paragraph 14.14) established for domestic building and loan associations to be able to maintain bad debt reserves under IRC Section 593.[2]

14.14 If a domestic building and loan fails to meet the IRC Section 7701(a)(19) definition, it generally, by default, is treated as a bank for tax purposes under IRC Section 581. The IRC provides a related three-part test at the institution level (not at the consolidated group level). A general description of the three tests follows.

a. *Supervisory test.* A domestic building and loan must be either a domestic building and loan association, a domestic savings and loan association, or a federal savings and loan association that is insured by the FDIC, or is subject by law to supervision and examination by state or federal authorities.

b. *Business operations test.* The principal business of a domestic building and loan must be to acquire the savings deposits of the public and to invest in loans. Either an institution must acquire the savings deposits of the public in conformity with Office of Thrift Supervision (OTS) regulations or state supervisory authority or the general public must hold more than 75 percent of the dollar amount of the institution's total deposits, withdrawable shares, and other obligations during the taxable year. An institution is considered to be in the business of investing in loans if the total of certain specified income items exceeds 75 percent of its gross income.

c. *Asset test.* A domestic building and loan must maintain at least 60 percent of its tax basis assets in qualifying assets. Qualifying assets include cash, taxable government debt obligations, loans secured by residential real estate, and residential real estate acquired through foreclosure. Qualifying loans used for purposes of the asset test, however, are not the same as qualifying loans for purposes of computing bad debt deductions. The 60 percent test is based on year-end assets; however, at the election of the institution, average assets can be used.

14.15 Institutions may fail to meet these definitions for a variety of reasons other than simply not holding enough of the right types of assets. An institution may change its charter or be acquired and merged into a bank. Also, in the year the institution fails to meet the definitional test, it may be required to recapture all or a portion of the tax bad debt reserves accumulated.

14.16 An institution also may be required to recapture a portion of its bad debt reserves if it makes distributions to shareholders that exceed earnings and profits accumulated after 1951. Additionally, if a savings institution makes a distribution in redemption of stock or in partial or complete liquidation, notwithstanding the existence of earnings and profits, a portion of the reserve may have to be recaptured. Exceptions to this rule exist for certain tax-free reorganizations and certain distributions to the FDIC in redemption

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[2] Historically, these institutions generally were identified by their state charters or Federal Deposit Insurance Corporation (FDIC) insurance. Regulatory changes since 1982, however, blurred this distinction and institutions not considered mutual savings banks sometimes attempt to qualify as domestic building and loan associations.

of an interest if such interest was originally received in exchange for assistance provided (see IRC Section 597(c)).

14.17 Failure of an institution to qualify as a savings institution may affect the financial accounting standards that apply (see paragraph 14.33).

14.18 ***Tax Bad Debt Deductions.*** IRC Section 593 provides that a bad debt deduction for savings institutions comprises two separate bad debt reserve additions. There are deductions for (*a*) the addition to the nonqualifying reserve and (*b*) the addition to the qualifying reserve. Qualifying loans generally include any loan secured by an interest in improved real property. Qualifying loans generally also include certain real estate acquired through foreclosure. In general, the definition of *qualifying real property loans* for bad debt purposes is not limited to residential real estate as it is for purposes of the 60% asset test. Nonqualifying loan generally means any loan that is not a qualifying real property loan. The addition to the nonqualifying reserve is computed using the bank experience method under IRC Section 585. The addition to the qualifying reserve generally is an amount not to exceed the larger of the amount computed using the bank experience method or an amount equal to 8 percent of taxable income (net of the amount to the nonqualifying reserve). If the percentage-of-taxable-income method is used, it represents the maximum deduction allowable for both qualifying and nonqualifying reserves.

14.19 The percentage-of-taxable-income bad debt deduction generally is computed as 8 percent of taxable income. Taxable income generally must be adjusted for—

- Bad debt reserve recapture from dividends paid in excess of earnings and profits or from redemptions of stock.
- Deductions for additions to the bad debt reserves.
- Dividends subject to the dividends-received deduction reduced by 8 percent of the dividends-received deduction.

Savings institutions that are included in tax returns of consolidated groups may also be required to adjust their taxable income with respect to losses of other members of the consolidated group, if those other members engage in activities that are "functionally related" to the thrift activities.

14.20 The percentage-of-taxable-income bad debt deduction is subject to two limitations, one based on total loans and another based on capital surplus. Under the loan limit, the ending reserve for losses on qualifying loans, after the current year's provision is added, generally is limited to an amount equal to 6 percent of the qualifying real property loans. The other test limits the overall addition to the reserve to the excess of 12 percent of the savings institution's withdrawable deposit accounts at the close of the year over the sum of its surplus, undivided profits, and tax-basis reserves at the beginning of the year.

14.21 ***Real Estate Acquired Through Foreclosure.*** Savings institutions are subject to special provisions for foreclosed property. Under IRC Section 595, a savings institution generally does not recognize, for tax purposes, gain, loss, or a charge-off as a result of foreclosure of real property. Instead, the foreclosed property generally is considered to retain the characteristics of the debt it secured. Accordingly, a post-foreclosure reduction in value generally is allowed to be treated in a manner similar to partially worthless debt and a bad debt deduction generally is allowed. Any gain or loss from the sale of foreclosed property generally is required to be treated as a recovery or charge-off on the underlying loan and therefore, reflected as part of the bad debt deduction. Thus, the tax and financial accounting methods for foreclosed property are substantially different.

Regulatory Matters

14.22 The Federal Financial Institutions Examination Council (FFIEC) requires, for regulatory reporting purposes, that income taxes be accounted for in conformity with generally accepted accounting principles (GAAP). However, income taxes receive special treatment in regulatory capital calculations as the federal banking regulatory agencies limit the amount of deferred tax assets that may be included in regulatory capital.

14.23 For institutions owned by holding companies, the agencies generally require tax-sharing payments between each institution and its holding company to equal the amount that would be currently payable to, or refundable from, a taxing authority as if the institution was filing its tax returns on a separate-entity basis. The rules generally require that deferred taxes of the institution may not be paid or transferred to, or forgiven by, its holding company.

14.24 Internal Revenue Service (IRS) regulations permit an institution to obtain evidence, from its primary regulator, stating that the institution maintains and applies loan review and loss classification standards consistent with the agency's regulations regarding loan charge-offs. Each of the federal banking regulatory agencies has implementing guidance on this express determination letter process.

Accounting and Financial Reporting

14.25 FASB Statement No. 109, *Accounting for Income Taxes*, establishes the accounting for the effects of income taxes that result from an institution's activities during the current and preceding years. It requires an asset-and-liability approach for financial accounting and reporting for income taxes and, therefore, has a balance-sheet orientation. The objectives of accounting for income taxes in conformity with FASB Statement No. 109 are to recognize (*a*) the amount of income taxes payable or refundable for the current year and (*b*) deferred tax liabilities and assets for future tax consequences of events that have been recognized in an institution's financial statements or tax returns.

14.26 FASB Statement No. 109 applies the following basic principles in accounting for income taxes at the date of the financial statements:

- A current income tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.
- A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards.
- The determination of the current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.
- The measurement of current and deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

Deferred Tax Assets and Liabilities

14.27 In general, FASB Statement No. 109 requires that a deferred tax liability be recognized for all taxable temporary differences (for example, book and tax bases differences that will result in future taxable amounts). Deferred tax assets are to be recognized for deductible temporary differences (that is, book and tax bases differences of assets and liabilities that will result in future deductible amounts) and for tax NOL and credit carryovers. The determination of deferred taxes (paragraph 17(e) of FASB Statement No. 109) includes reduction of deferred tax assets by a valuation allowance (as defined) if—

> based on the weight of available evidence, it is *more likely than not* (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized.

14.28 The paragraph further requires that the valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized. Paragraph 26 of FASB Statement No. 109 generally requires that a change in the amount of the valuation allowance be recognized in income in the period of the change.

Temporary Differences

14.29 A temporary difference is a difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the assets or liability is recovered or settled, respectively (see paragraph 289 of FASB Statement No. 109). Examples of temporary differences common to banks or savings institutions follow.

- *Bad debt reserves* for institutions that deduct bad debt reserves under IRC Sections 585 and 593 because, for larger institutions that are covered under IRC Section 166, there is no bad debt reserve for tax purposes and, therefore, the entire allowance for credit losses in the financial statements is a temporary difference.
- *Unrealized gains or losses on securities* under FASB Statement No. 115 may differ from amounts recognized under IRC Section 475.
- *Other real estate owned and other assets* may reflect post-acquisition impairment write-downs in the financial statements; those write-downs are generally not recognized for tax purposes until the asset is sold or disposed of for a bank. (For a savings institutions, these assets will generally be treated as a loan until sold.)
- *Accrued deferred compensation* is not deductible for tax purposes until paid.
- *Accrued loss contingencies* are generally not deductible for tax purposes until paid.
- *Depreciation of property, plant, and equipment* and amortization of intangible assets may be different for financial statement and tax purposes.
- *Accrual of retirement liabilities* is often made in the financial statements in different periods from those in which the expense is recognized for tax purposes.
- *Basis differences* in assets and liabilities are caused by the following:
  - *Gains and losses on sales* of loans, foreclosed assets, or property, plant, and equipment recognized in financial reporting periods different from tax periods

- *Amortization of imputed interest income* from transactions involving loans recognized in different periods for financial reporting and tax purposes
- *Accretion of discount on securities* recorded currently for financial reporting purposes, but subject to tax at maturity or sale, or accreted differently for tax purposes
- *Carryover tax basis of assets and liabilities* in a transaction that is accounted for under the purchase method of accounting in accordance with Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*
- *Commitment fees* included in taxable income when collected but deferred to a period when earned for financial reporting purposes
- *Loan fee income* recognized on a cash basis for tax purposes while recognized as a yield adjustment for financial reporting purposes
- *Federal Home Loan Bank (FHLB) stock dividends* recognized as current financial reporting income but deferred for tax purposes
- The timing of the recognition of *income or loss for hedges and swaps* that differ for financial reporting and tax purposes

Lease Financing

14.30 Paragraph 43 of FASB Statement No. 13, *Accounting for Leases*, requires a lessor to defer and amortize any related investment tax credit (ITC) in the initial and continuing investment in a leveraged lease. For tax purposes, some institutions (as lessors) have classified a deferred ITC as part of the net investment in lease financing and reported the amortization of the ITC on both leveraged and financing leases as operating income rather than as a component of the income tax provision, because they view the ITC amortization as an integral part of their return on the lease financing. Other lessors have reported the amortization of the ITC as a component of the income tax provision. The lessor should disclose, in the financial statements, the method followed. [3]

Financial Statement Presentation and Disclosure

14.31 Paragraphs 41 through 49 of FASB Statement No. 109 establish requirements for financial statement presentation and disclosure of income taxes.

14.32 Paragraph 44 of FASB Statement No. 109 requires that, whenever a deferred tax liability is not recognized because of certain exceptions addressed by APB Opinion No. 23, *Accounting for Income Taxes—Special Areas* (as amended by FASB Statement No. 109), the following information should be disclosed—

- A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable
- The cumulative amount of each type of temporary difference
- The amount of unrecognized deferred tax liability for temporary differences related to investments in foreign subsidiaries and foreign

[3] The Tax Reform Act of 1986 (TRA 86) repealed the ITC for property placed in service after December 31, 1985. Further, the allowable post-1986 ITC for transition property and/or ITC carryforwards has been reduced by 35 percent for tax years beginning after June 30, 1987. The reduction of ITC is phased in for tax years beginning before and ending after July 1, 1987.

joint ventures that are essentially permanent in duration if determination of that liability is practicable or a statement such determination is not practicable

- The amount of the deferred tax liability for other temporary differences that is not recognized in accordance with the provisions of paragraphs 31 and 32 of FASB Statement No. 109

14.33 Bad debt reserves for tax purposes of U.S. savings institutions (and other qualified thrift lenders) that arose in tax years beginning before December 31, 1987 (that is, the base-year amount), are included in paragraph 31 of FASB Statement No. 109 as one example of temporary differences of banks or savings institutions for which a deferred tax liability is not recognized when the "indefinite reversal criteria" of APB Opinion No. 23 are met.

14.34 Paragraph 46 of FASB Statement No. 109 requires that institutions disclose the amount of income tax expense or benefit allocated to continuing operations and the amounts separately allocated to other items addressed in paragraphs 35 through 39 of the Statement. For example, the amount of income tax expense or benefit allocated to certain items whose tax effects are charged or credited directly to related components of shareholders' equity (such as translation adjustments under FASB Statement No. 52, *Foreign Currency Translation*, or changes in the unrealized holding gains and losses of securities classified as available-for-sale under FASB Statement No. 115) should be separately allocated and disclosed.

Auditing

Objectives

14.35 The objectives of auditing income taxes are to obtain reasonable assurance that—

a. The provision for income taxes and the reported income tax liability or receivable are properly measured, valued, classified, and described in accordance with GAAP.

b. Deferred income tax liabilities and assets accurately reflect the future tax consequences of events that have been recognized in the institution's financial statements or tax returns (temporary differences and carryovers).

Planning

14.36 The independent accountant should be aware that the tax laws specific to banks and savings institutions, as well as to general corporate taxation, can change from year to year.

Internal Control Structure Over Financial Reporting and Possible Tests of Controls

14.37 The independent accountant should obtain an understanding of relevant internal control structure policies and procedures. It may be more efficient and effective to assess control risk at the maximum for income taxes and take an entirely substantive approach. Chapter 3 discusses related considerations.

Substantive Tests

14.38 Substantive audit procedures may include the following—

- Obtain a schedule reconciling net income per books with taxable income for federal, state, and foreign income taxes. Agree entries to general ledger and supporting documents as appropriate. Consider the reasonableness of the current tax account balances.
- Update or review the schedule of cumulative temporary differences, reviewing for propriety, and test the reasonableness of the income tax amounts.
- Review and determine the need for and appropriateness of any valuation allowance for deferred tax assets. The auditor should recognize that institutions often may have a significant deferred tax asset resulting from the loan loss reserve. This asset should be evaluated based upon the likelihood of realization, taking into account the timing of the bad debt deduction, and the special NOL carryovers and carryback tax rules, if applicable.
- Consider the deductibility of transactions such as profit-sharing, bonus, contributions, or stock option transactions.
- Review classification and description of accounts to identify possible tax reporting differences such as reserves for anticipated losses or expenses.
- Review the tax status and consolidated return requirements of subsidiaries.
- Review the status of current-year acquisitions of other companies and their preacquisition tax liabilities and exposures.
- Review the utilization of carryovers.
- Review the allocation, apportionment, and sourcing of income and expense applicable to state tax jurisdictions with significant income or franchise taxes.
- For separate financial statements of affiliates, review terms of all tax-sharing agreements between affiliated entities to determine proper disclosure and accounting treatment. The auditor should be cognizant of and consider whether the institution is in compliance with the regulatory accounting rules for intercompany tax allocation and settlement.
- Review schedule of NOL and other tax credit carryforwards.
- Review tax planning strategies and assumptions utilized in the calculation of deferred income taxes under FASB Statement No. 109.
- Test the rollforward of tax balance-sheet accounts. Consider vouching significant tax payments and credits.
- Review reconciliation of prior-year tax accrual to the actual filed tax return.
- Determine the propriety of adjustments made in this regard and consider the impact on the current year's tax accrual.
- Examine prior-year income tax returns, and ascertain the latest year for which returns have been examined.
- Evaluate tax contingencies and consider the appropriate accounting treatment and disclosure requirements for these items under FASB Statement No. 5, *Accounting for Contingencies*. Review recent Reve-

nue Agent Reports, if any, and consider current treatment of items challenged by the taxing authorities in prior years for impact on tax contingencies. The auditor should also review Coordinated Issue Papers issued by the IRS for banks and savings institutions to determine their impact on tax contingencies.

- Ascertain whether changes in income tax laws and rates have been properly reflected in the tax calculations and account balances.
- Evaluate the adequacy of the financial statement disclosures.

Chapter 15

Futures, Forwards, Options, Swaps, and Similar Financial Instruments

Introduction

15.01 The financial instruments addressed in this chapter—futures; forward, swap, and option contracts; and other financial contracts with similar characteristics (which, collectively, are referred to in this chapter as *derivatives*)—have become important financial management tools for banks and savings institutions.[1] This chapter provides background information on basic contracts, risks, and other general considerations to provide a context for related accounting and auditing guidance.

15.02 This chapter focuses on end uses of derivatives, rather than on the broader range of activities that includes the marketing of derivatives to others. Some banks and savings institutions, primarily large commercial banks, act as market makers or dealers in derivatives that are not traded under uniform rules through an organized exchange. The primary goals of those activities are to make a market and earn income on the difference between the bid and offer prices. Although the volume of transactions often causes individual exposures to offset each other, such activities may be subject to different permutations of risks and different accounting and auditing considerations.

Risks Inherent in Derivatives

15.03 Risks inherent in derivatives—such as credit risk, market risk, legal risk, and control risk—are the same as risks inherent in more familiar financial instruments. However, derivatives often possess special features such as—

- Little or no cash outflows or inflows required at inception.
- No principal balance or other fixed amount to be paid or received.
- Potential risks and rewards substantially greater than the amounts recognized in the statement of financial position.

Also, many derivatives' values are more volatile than those of other financial instruments—potentially alternating between positive and negative values in a short period of time.

15.04 Given these features, a derivative's risks can be difficult to segregate because the interaction of such risks may be complex. This complexity is increased (*a*) when two or more basic derivatives are used in combination, (*b*) by the difficulty of valuing complex derivatives, and (*c*) by the volatile nature

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[1] Paragraph 5 of the Financial Accounting Standards Board's (FASB's) Statement of Financial Accounting Standards No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, defines a derivative financial instrument as "a futures, forward, swap, or option contract, or other financial instrument with similar characteristics." Asset-backed securities, which are addressed in chapter 5, also are often referred to as derivatives though they do not meet the definition of *derivative financial instrument* for the purposes of FASB Statement No. 119.

of markets for some derivatives. The economic interaction between an institution's position in derivatives and that institution's other on- or off-balance-sheet positions (whether assets or liabilities) is an important determinant of the total risk associated with an institution's derivatives use. Risk assessment, therefore, involves consideration of the specific instrument and its interaction with other on- and off-balance-sheet portfolios and activities. There is no list of risk characteristics that can cover all those complex interactions, but a discussion of the basic risk characteristics associated with derivatives follows.

15.05 ***Credit Risk.*** This risk relates to the economic losses an institution would suffer if the party on the other end of the contract (the counterparty) fails to meet its financial obligations under the contract. Entities often quantify this risk of loss as the derivative's replacement cost—that is, the current market value of an identical contract.[2] The requirement that participants settle changes in the value of their positions daily mitigates the credit risk of many derivatives traded under uniform rules through an organized exchange (exchange-traded derivatives). *Settlement risk* is the related exposure that a counterparty may fail to perform under a contract after the institution has delivered funds or assets according to its obligations under the contract. Institutions can reduce settlement risk through master netting agreements (see paragraph 15.25 and following). *Counterparty risk* connotes the exposure to the aggregate credit risk posed by all transactions with one counterparty.

15.06 ***Market Risk.*** This risk relates broadly to economic losses due to adverse changes in the fair value of the derivative.[3] Related risks include price risk, basis risk, liquidity risk, and valuation or model risk. *Price risk* relates to changes in the level of prices due to changes in (*a*) interest rates, (*b*) foreign exchange rates, or (*c*) other factors that relate to market volatilities of the rate, index, or price underlying the derivative. *Basis risk* relates to the differing effect market forces have on the performance or value of two or more distinct instruments used in combination (see the discussion of hedging that follows). *Liquidity risk* relates to changes in the ability to sell, dispose of, or close out the derivative, thus affecting its value. This may be due to a lack of sufficient contracts or willing counterparties. *Valuation or model risk* is the risk associated with the imperfection and subjectivity of models and the related assumptions used to value derivatives.

15.07 ***Legal Risk.*** This risk relates to losses due to a legal or regulatory action that invalidates or otherwise precludes performance by the institution or its counterparty under the terms of the contract or related netting arrangements. Such risk could arise, for example, from insufficient documentation for the contract, an inability to enforce a netting arrangement in bankruptcy, adverse changes in tax laws, or statutes that prohibit entities (such as certain state and local governmental entities) from investing in certain types of financial instruments.

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[2] There is a fundamental difference between the credit risk associated with on-balance-sheet financial assets (such as notes receivable or debt securities) and that associated with derivatives—the amount of credit exposure in a derivative is volatile, as it will vary with changes in the derivative's market value. Generally, a derivative has credit exposure only when the derivative has positive market value. That value represents an obligation of the counterparty and, therefore, an economic benefit that can be lost if the counterparty fails to fulfill its obligation. Furthermore, the market value of a derivative may fluctuate quickly, alternating between positive and negative values.

[3] Market risk can be measured using a methodology referred to as *value at risk*. Paragraph 69(e) of FASB Statement No. 119 defines value at risk as "the expected loss from an adverse market movement with a specified probability over a period of time." The Group of Thirty report *Derivatives: Practices and Principles* discusses measurement of risk and the concept of value at risk.

15.08 ***Control Risk.*** This risk relates to losses that result from the failure (or absence) of internal controls to prevent or detect problems (such as human error, fraud, or system failure) that hinder an institution from achieving its operational, financial reporting, or compliance objectives. Such failure could result, for example, in an institution failing to understand a contract's economic characteristics. Lack of adequate control also could affect whether published financial information about derivatives was prepared reliably by a failure to prevent or detect errors or irregularities in financial reporting. Finally, the institution may be negatively affected if controls fail to prevent or detect instances of noncompliance with related contracts, laws, or regulations. Failure to understand derivatives used may lead to inadequate design of controls over their use.

Types of Derivatives

15.09 A key feature of derivatives, as defined in this chapter, is that resulting cash flows are decided by reference to—

a. Rates, indexes (which measure changes in specified markets), or other independently observable factors.

b. The value of underlying positions in the following:
- Financial instruments such as government securities (interest-rate contracts), equity instruments (such as common stock), or foreign currencies
- Commodities such as corn, gold bullion, or oil
- Other derivatives

15.10 Derivatives can generally be described as either *forward-based or option-based,* or there can be combinations of the two. A traditional forward contract obligates one party to buy and a counterparty to sell an underlying financial instrument, foreign currency, or commodity at a future date at an agreed-upon price. Thus, a *forward-based derivative* (examples are futures, forward, and swap contracts) is a two-sided contract in that each party potentially has a favorable or unfavorable outcome resulting from changes in the value of the underlying position or the amount of the underlying reference factor. A traditional option contract provides one party that pays a premium (the option holder) with a right, but not an obligation, to buy (call options) or sell (put options) an underlying financial instrument, foreign currency, or commodity at an agreed-upon price on or before a predetermined date. The counterparty (the option writer) is obligated to sell (buy) the underlying position if the option holder exercises the right. Thus, *an option-based derivative* (examples are option contracts, interest rate caps, and interest-rate floors) is one-sided in the sense that, in the event the right is exercised, only the holder can have a favorable outcome and the writer can have only an unfavorable outcome. If market conditions would result in an unfavorable outcome for the holder, the holder will allow the right to expire unexercised. The expiration of the option contract results in a neutral outcome for both parties (except for any premium paid to the writer by the holder). Although there are a variety of derivatives, they generally are variants or combinations of these two types of contracts.

15.11 Derivatives also are either exchange-traded or over-the-counter (OTC). Institutions and dealers trade futures, certain option, and other standardized contracts under uniform rules through an organized exchange. Most of the risk inherent in such exchange-traded derivatives relates to market risk rather than to credit risk. OTC derivatives are privately traded instruments (primarily swap, option, and forward contracts) customized to meet specific needs and for which the counterparty is not an organized exchange. As a result, although OTC derivatives are more flexible, they potentially involve higher credit and liquidity risk. The degree of risk depends on factors such as (*a*) the financial strength of the counterparty, (*b*) the sufficiency of any collateral held, and (*c*) the liquidity of the specific instrument. The advantages of OTC derivatives are that they can be customized and may be easier to use.

15.12 A description of the basic contracts and variations follows.

15.13 ***Forwards.*** *Forward contracts* are contracts negotiated between two parties to purchase and sell a specific quantity of a financial instrument, foreign currency, or commodity at a price specified at origination of the contract, with delivery and settlement at a specified future date.[4] Forward contracts are not traded on exchanges and, accordingly, may be less liquid and generally involve more credit and liquidity risk than futures contracts.

15.14 *Forward-rate agreements,* which are widely used to manage interest-rate risk, are forward contracts that specify a reference interest rate and an agreed-upon interest rate (one to be paid and one to be received) on an assumed deposit of a specified maturity at a specified future date (the settlement date).[5] The term of the assumed deposit may begin at a subsequent date; for example, the contract period may be for six months, commencing in three months. At the settlement date, the seller of the forward-rate agreement pays the buyer if interest calculated at the reference rate is higher than that calculated at the agreed-upon rate; conversely, the buyer pays the seller if interest calculated at the agreed-upon rate is higher than that calculated at the reference rate.

15.15 ***Futures.*** *Futures contracts* are forward-based contracts to make or take delivery of a specified financial instrument, foreign currency, or commodity at a specified future date or during a specified period at a specified price or yield.[6] Futures are standardized contracts traded on an organized exchange. The deliverable financial instruments underlying interest-rate futures contracts are specified investment-grade financial instruments, such as U.S. Treasury securities or mortgage-backed securities (MBSs). *Foreign-currency futures contracts* involve specified deliverable amounts of a particular foreign currency. The deliverable products under *commodities futures contracts* are specified amounts and grades of commodities, such as oil, gold bullion, or coffee.

15.16 Active markets exist for most financial and commodities futures contracts. Active markets provide a mechanism by which entities may transfer their exposures to price risk to other parties. Those parties may, in turn, be trying to manage their own financial risks or achieve gains through speculation. Recognized exchanges, such as the International Monetary Market (a division of the Chicago Mercantile Exchange) or the Chicago Board of Trade, establish conditions governing transactions in futures contracts. U.S. Treasury bond (interest-rate) futures contracts are the most widely traded financial futures contracts. To ensure an orderly market, the exchanges specify maximum

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[4] Forward and futures contracts can also be based on an index, such as Standard & Poor's Composite Index of 500 Stocks (the S&P 500).

[5] Examples of reference rates include the U.S. Treasury bill rate and the London Interbank Offered Rate (LIBOR), which is the rate international banks charge each other to borrow money.

[6] See footnote 4 in this chapter.

daily price fluctuations for each type of contract. If the change in price from the previous day's close reaches a specified limit, no trades at a higher or lower price are allowed. Consequently, trading in the contract is stopped until buy orders and sell orders can be matched either within the daily price limits or on the next business day. Such limits may affect liquidity and thereby hinder the effectiveness of futures contracts used as hedges.

15.17 Brokers require both buyers and sellers of futures contracts to deposit assets (such as cash, government securities, or letters of credit) with a broker. Such assets represent the initial margin (which is a good-faith deposit) at the time the contract is initiated. The brokers mark open positions to market daily and either call for additional assets to be maintained on deposit when losses are experienced (a margin call) or credit customers' accounts when gains are experienced. This daily margin adjustment is called *variation margin*. Variation margin payments generally must be settled daily in cash or acceptable collateral, thus reducing credit risk. The broker returns the initial margin when the futures contract is closed out or the counterparty delivers the underlying financial instrument according to the terms of the contract.

15.18 Delivery of the commodity or financial instrument underlying futures contracts occurs infrequently, as contracts usually are closed out before maturity. This close-out process involves the participants entering a futures contract that is equal and opposite to a currently held futures contract. This provides the participant with equal and opposite positions and obligations and eliminates any net obligation during the remaining lives of the futures contracts.

15.19 ***Swaps***. *Swap contracts* are forward-based contracts in which two parties agree to swap streams of payments over a specified period. The payment streams are based on an agreed-upon (or notional) principal amount. The term *notional* is used because swap contracts generally involve no exchange of principal at either inception or maturity. Rather, the notional amount serves as a basis for calculation of the payment streams to be exchanged.

15.20 *Interest-rate swaps* are the most prevalent type of swap contract. One party generally agrees to make periodic payments, which are fixed at the outset of the swap contract. The counterparty agrees to make variable payments based on a market interest rate (index rate). Swap contracts allow institutions to achieve net payments similar to those that would be achieved if the institution actually changed the interest rate of designated assets or liabilities (the underlying cash position) from floating to fixed rate or vice versa.

15.21 Interest-rate swap contracts are considered a flexible means of managing interest-rate risk. Because swap contracts are customized for institutions, terms may be longer than futures contracts, which generally have delivery dates from three months to three years. Swap contract documentation usually is standardized and transactions can be concluded quickly, making it possible to rapidly take action against anticipated interest-rate movements.

15.22 Interest-rate swap contracts normally run to maturity. However, there may be circumstances that eliminate an institution's need for the swap contract before maturity. Accordingly, an institution may cancel contracts, sell its position, or enter an offsetting swap contract and realize gains or losses, depending on the value of the swap.

15.23 Swap contracts are not exchange-traded but negotiated between two parties. Therefore, they are not as liquid as futures contracts. They also lack the credit risk protection provided by regulated exchanges. The failure by a counterparty to make payments under a swap contract usually results in an economic loss to an institution only if the underlying prices (for example, interest rates or foreign exchange rates) have moved in an adverse direction; that is, in the direction that the swap contract was intended to protect against. The economic loss corresponds to the cost to replace the swap contract. That cost would be the present value of any discounted net cash inflows that the swap contract would have generated over its term.

15.24 In some swap contracts, the timing of payments varies. For example, in an interest-rate swap contract, one party might pay interest quarterly while the counterparty pays interest semiannually. An added element of credit risk exists for the quarterly payer because of the risk that the semiannual payer may default. Here, the economic loss equals the lost quarterly payment and the cost of replacing the swap contract.

15.25 Many entities enter legally enforceable master netting agreements that may reduce total credit risk. Upon default by an applicable counterparty, the agreements provide that entities may set off (for settlement purposes) all their related payable and receivable swap contract positions.

15.26 *Foreign-currency swaps* (sometimes called *cross-currency exchange agreements)* are used to fix (for example, in U.S. dollar terms) the value of foreign exchange transactions that will occur in the future. Foreign-currency swap contracts are also used to transfer a stream of cash flows denominated in a particular currency or currencies into another currency or currencies. Basic features of foreign-currency swap contracts include the following:

- The principal amount is usually exchanged at the initiation of the swap contract.
- Periodic interest payments are made based on the outstanding principal amounts at the respective interest rates agreed to at inception.
- The principal amount is usually re-exchanged at the maturity date of the swap contract.

15.27 In *fixed-rate-currency swaps*, two counterparties exchange fixed-rate interest in one currency for fixed-rate interest in another currency. Currency coupon or cross-currency interest-rate swap contracts combine the features of an interest-rate swap contract and a fixed-rate-currency swap contract. That is, the counterparties exchange fixed-rate interest in one currency for floating-rate interest in another currency.

15.28 *Basis swaps* are a variation on interest-rate swap contracts where both rates are variable but are tied to different index rates. For example, one party's rate may be indexed to three-month LIBOR while the other party's rate is indexed to six-month LIBOR.

15.29 *Equity swaps* are contracts in which the counterparties exchange a series of cash payments based on (*a*) an equity index and (*b*) a fixed or floating interest rate on a notional principal amount. Equity swap contracts typically are tied to a stock index, but sometimes they relate to a particular stock or a defined basket of stocks. One party (the equity payer) pays the counterparty (the equity receiver) an amount equal to the increase in the stock index at regular intervals specified in the contract. Conversely, the equity receiver must pay the equity payer if the stock index declines. The counterparties generally make quarterly payments. Whatever the index performance, the party designated as the equity receiver may also receive an amount representing dividends paid by the companies making up the index during the period.

15.30 The equity payer, on a floating-rate equity swap contract, typically receives LIBOR (plus or minus a notional spread) on the notional principal amount defined in the equity swap contract. This notional principal amount is based on the underlying equity index value at the contract's inception. The notional principal amount is adjusted at each payment date to reflect the settlement of the equity gain or loss. The floating rate is also reset on the periodic payment dates. A fixed-rate equity swap contract is essentially the same, except that the interest rate is fixed for the term of the contract.

15.31 *Commodity swaps* are contracts in which the counterparties agree to exchange cash flows based on the difference between an agreed-upon, fixed price and a price that varies with changes in a specified commodity index, as applied to an agreed-upon quantity of the underlying commodity.

15.32 In *mortgage swaps*, two counterparties exchange contractual payments designed to replicate the net cash flows of a portfolio of MBSs financed by short-term floating-rate funds. For example, mortgage swaps enable an institution to finance mortgage securities at a rate tied to a floating-rate index below LIBOR on a guaranteed, multiyear basis. Mortgage swaps have been described as being similar to an amortizing interest-rate swap (rather than one with a fixed notional principal amount) with a long-term forward commitment to purchase MBSs. In a typical mortgage swap transaction, an investor contracts with a third party to receive cash flows based on a generic class of MBSs over a specified period in exchange for the payment of interest at a rate typically based on LIBOR. The payments are made as if there were an underlying notional pool of mortgage securities. Payments are exchanged on a monthly basis. The cash flows received by the investor are derived not only from the fixed coupon on the generic class of securities but also, to the extent that the coupon is above or below par, from the benefit or loss implicit to the discount or premium. The notional amount of the mortgage swap is adjusted monthly, based on the amortization and prepayment experience of the generic class of MBSs.

15.33 The contract may require the investor either to take physical delivery of mortgages at a predetermined price (for example, a percentage of the par amount of mortgages remaining in the pool) when the contract expires or to settle in cash for the difference between the predetermined price of the mortgages and their current market value as determined by the dealer.

15.34 Credit risk for mortgage swaps is the possibility that the dealer will be unable to deliver the mortgages when the contract terminates. If the dealer cannot perform, and if the mortgages are selling above the original contract price at settlement, the investor suffers a loss and can also lose any margin or collateral retained by the dealer against the ultimate purchase of the mortgage securities. Similarly, the investor is also exposed to counterparty default risk on the interest-rate swap component of the transaction over the term of the contract.

15.35 At the time the mortgage swaps are initiated, the investor generally posts initial collateral with the dealer. Additional collateral is taken by the dealer or returned to the investor based on changes in the market price of the underlying mortgages. This two-way collateral policy reduces counterparty credit risk.

15.36 ***Options.*** *Option contracts* are traded on an exchange or over the counter (that is, they are negotiated between two parties). Option contracts allow, but do not require, the holder (or purchaser) to buy (call) or sell (put) a specific or standard commodity, or financial or equity instrument, at a specified price during a specified period (an American option) or at a specified date (a European option).[7] Furthermore, certain option contracts may involve cash settlements based on changes in specified indexes, such as stock indexes. Again, the principal difference between option contracts and either futures or forward contracts is that an option contract does not require the holder to exercise the option, whereas performance under a futures or forward contract is mandatory.

15.37 At the inception of an option contract, the holder typically pays a fee, which is called a *premium,* to the writer (or seller) of the option. The premium includes two values, the intrinsic value and the time value. The *intrinsic value* of a call option is the excess, if any, of the market price of the item underlying the option contract over the price specified in the option contract (the strike price or the exercise price). The intrinsic value of a put is the excess, if any, of the option contract's strike price over the market price of the item underlying the option contract. The intrinsic value of an option cannot be less than zero. The other component of the premium's value is the time value. The *time value* reflects the probability that the price of the underlying item will move above the strike price (for a call) or below the strike price (for a put) during the exercise period.

15.38 The advantage of option contracts held is that they can be used to mitigate downside price risk without totally negating upside profit potential. This is because the loss on a purchased option contract is limited to the amount paid for the option contract. Profit on written option contracts is limited to the premium received but the loss potential is unlimited because the writer is obligated to settle at the strike price if the option is exercised.

15.39 Option contracts are frequently processed through a clearinghouse that guarantees the writer's performance under the contract. This reduces credit risk, much like organized exchanges reduce credit risk for futures contracts. Thus, such option contracts are primarily subject to market risk. However, for option contracts that are not processed through the clearing-house, the holder may have significant credit and liquidity risks.

15.40 Different option contracts can be combined to transfer risks from one entity to another. Examples of such option-based derivatives are caps, floors, collars, and swaptions.

15.41 *Interest-rate caps* are contracts in which the cap writer, in return for a premium, agrees to limit, or cap, the cap holder's risk associated with an increase in interest rates. If rates go above a specified interest-rate level (the strike price or the cap rate), the cap holder is entitled to receive cash payments equal to the excess of the market rate over the strike price multiplied by the notional principal amount. Issuers of floating-rate liabilities often purchase caps to protect against rising interest rates while retaining the ability to benefit from a decline in rates.

15.42 Because a cap is an option-based contract, the cap holder has the right but not the obligation to exercise the option. If rates move down, the cap holder has lost only the premium paid. Because caps are not exchange-traded, however, they expose the cap holder to credit risk because the cap writer could fail to fulfill its obligations.

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[7] Option-based derivatives do not necessarily include an explicit option that requires deliberate exercise by the holder. Instead, the holder receives the benefit automatically under the terms of the contract (for example, when the interest rate exceeds desired levels).

15.43 A cap writer has virtually unlimited risk resulting from increases in interest rates above the cap rate. However, the cap writer's premium may potentially provide an attractive return.

15.44 *Interest-rate floors* are similar to interest-rate caps. Interest-rate floors are contracts in which the floor writer, in return for a premium, agrees to limit the risk associated with a decline in interest rates based on a notional amount. If rates fall below an agreed rate, the floor holder will receive cash payments from the floor writer equal to the difference between the market rate and an agreed rate multiplied by the notional principal amount. Floor contracts allow floating-rate lenders to limit the risk associated with a decline in interest rates while benefiting from an increase in rates. As with interest-rate caps, the floor holder is exposed to credit risk because the floor writer could fail to fulfill its obligations.

15.45 *Interest-rate collars* combine a cap and a floor (one held and one written). Interest-rate collars enable an institution with a floating-rate contract to lock into a predetermined interest-rate range.

15.46 *Swaptions* are option contracts to enter an interest-rate swap contract at some future date or to cancel an existing swap contract in the future. As such, a swaption contract may act as a floor or a cap for an existing swap contract or be used as an option to enter, close out, or extend a swap contract in the future.

Uses of Derivatives to Alter Risk

15.47 Financial market participants have created a large variety of derivatives. Not only are there basic contracts, but there are variants tailored to add, subtract, multiply, or divide the related risk and reward characteristics and thereby satisfy specific risk objectives of the parties to the transactions. Such innovation has been driven by the users' desire to cope with (or attempt to take advantage of) market volatility in foreign exchange rates, interest rates, and other market prices; deregulation; tax law changes; and other broad economic or business factors. An institution may attempt to alter such risks (*a*) at a general level (that is, the overall risk exposures faced by the institution), (*b*) at the level of specific portfolios of assets or liabilities, or (*c*) narrowly to a specific asset, liability, or anticipated transaction. Uses of derivatives to alter risks range from uses that help mitigate or control volatile risk exposures (activities that include the idea of taking defensive action against risk through hedging) to uses that increase exposures to risk and, by that, the potential rewards (the idea of offensive action, often considered as trading or speculation). However, distinguishing between activities that dampen or increase the volatility of risk exposures can be difficult.

15.48 ***Speculation.*** *Speculation* involves the objective of profiting by entering into an exposed position, that is, assuming risk in exchange for the opportunity to profit from anticipated market movements. A speculator believes that the cash market price of an underlying commodity, financial instrument, or index will change so that the derivative produces net cash inflows or can be closed out in the future at a profit.

15.49 ***Risk Management.*** Some institutions use the volatility of derivatives to increase or decrease risks associated with existing or anticipated on- or off-balance sheet transactions.[8] Institutions often manage financial risks

[8] Although risk management is often read to connote risk reduction, the distinction between certain risk management activities and speculative activities is not well defined.

both generally (through management of the overall mix of financial assets and liabilities) and specifically (through hedges of specific risks or transactions).

15.50 Some entities continually analyze and manage financial assets and liabilities based on their payment streams and interest rates, the timing of their maturities, and their sensitivity to actual or potential changes in market prices or interest rates. Such activities fall under the broad definition of *asset/liability management.* Some institutions purchase derivatives to help manage and select their total exposure to interest-rate risk. Institutions also purchase derivatives to create synthetic instruments. Those synthetic instruments can be used in the institution's asset/liability management activities to synthetically alter the interest income and expense flows of certain assets or liabilities. For example, an institution can convert the cash flow pattern and market risk profile of floating-rate debt to those of fixed-rate debt by entering an interest-rate swap contract.

15.51 *Hedging* connotes a risk alteration activity to protect against the risk of adverse price or interest-rate movements on certain of an institution's assets, liabilities, or anticipated transactions.[9] A *hedge* is a defensive strategy. It is used to avoid or reduce risk by creating a relationship by which losses on certain positions (assets, liabilities, or anticipated transactions) are expected to be counterbalanced in whole or in part by gains on separate positions in another market. For example, an institution may want to attempt to fix the value of an asset, the sales price of some portion of its future production, the rate of exchange for payments to its suppliers, or the interest rates of an anticipated issuance of debt.

15.52 The use of various financial instruments to reduce certain risks results in the hedger's assuming a different set of risks. Effective control and management of risks through hedging, therefore, require a thorough understanding of the market risks associated with the financial instrument that is part of the hedging program.

15.53 *Basis risk* is an important risk encountered with most hedging contracts. As introduced above, basis is the difference between the cash market price of the instrument or other position being hedged and the price of the related hedging contract. The institution is subject to the risk that the basis will change while the hedging contract is open (that is, the price correlation will not be perfect). Changes in basis can occur continually and may be significant. Changes in basis can occur even if the position underlying the hedging contract is the same as the position being hedged. However, entities often enter a hedging contract, such as a futures contract, on a position that is different from the position being hedged. Such *cross-hedging* increases the basis risk.

15.54 As cash market prices change, the prices of related hedging contracts change, but not necessarily to the same degree. *Correlation* is the degree to which hedging contract prices reflect the price movement in the cash market. The higher the correlation between changes in the cash market price and the hedging contract's price, the higher the precision with which the hedging contract will offset the price changes of the position being hedged.

15.55 Gains or losses on the hedge position will not exactly offset the exposed cash market positions when the basis changes. The institution might

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[9] This discussion of hedging is broader than, and should not be confused with, the criteria in generally accepted accounting principles (GAAP) that must be met to achieve hedge accounting. (See paragraphs 15.68 and following.)

enter a hedge when (*a*) it is perceived that the risk of a change in basis is lower than the risk associated with the cash market price exposure or (*b*) there is the ability to monitor the basis and to adjust the hedge position in response to basis changes.

15.56 Basis changes in response to many factors. Among them are (*a*) economic conditions, (*b*) supply and demand for the position being hedged, (*c*) liquidity of the cash market and the futures market for the instrument, (*d*) the credit rating of the cash instrument, and (*e*) the maturity of the instrument being hedged as compared with the instrument represented in the hedging contract. A discussion of how these factors affect basis is beyond the scope of this chapter. However, convergence—a significant contributor to a change in the basis over time—warrants mention.

15.57 *Convergence* is the shrinking of the basis between the hedging contract's price and the cash market price as the contract delivery date approaches. The hedging contract's price includes an element related to the time value up to the expiration of the contract. Convergence results from the delivery feature of hedging contracts that encourages the price of an expiring contract to equal the price of the deliverable cash market instrument on the day that the contract expires. As the delivery day approaches, prices generally fluctuate less and less from the cash market prices because the effect of expectations related to time is diminishing.

15.58 *The correlation factor* represents the potential effectiveness of hedging a cash market instrument with a contract where the deliverable financial instrument differs from the cash market instrument. The correlation factor generally is determined by regression analysis or another method of technical analysis of market behavior. When a high degree of positive correlation has historically existed between the hedging instrument price and the cash market price of the instrument being hedged, the risk of price variance associated with a cross-hedge is expected to be lower than the risk of not being hedged. Institutions usually employ the correlation factor to analyze cross-hedging risk at the inception of the hedge, while actual changes in the relative values of the hedge instrument and the hedged item usually are employed throughout the hedge period to measure correlation.

Variations on Basic Derivatives

15.59 Some derivatives combine two or more basic contracts and thereby the risk and reward characteristics of several different products. Written options and other variations embedded in certain derivative and nonderivative contracts can magnify interest-rate and other risks assumed by the institution as end user. Included may be variations affecting the term, notional amount, interest rate, or specified payments. These variations have the potential to produce higher cash inflows or outflows than similar instruments that do not contain the option feature. This follows the general rule that the greater the potential return, the higher the risk.

15.60 ***Embedded Written Options.*** Some swap contracts involve the institution's writing of options that the counterparty issuer may exercise if certain changes occur in the index rate or under other specified circumstances. For example, the counterparty issuer may be given the option to—[10]

- Extend or shorten the term of the contract.

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[10] See footnote 7 in this chapter.

- Require the institution to purchase securities at a fixed price.
- Put a cap on variable payments to be received by the institution.

15.61 As with most option contracts (and allowing for the effect of the premium paid for the contract) the holder of the option (here, the counterparty) has a potentially favorable (or neutral) outcome, while the writer of the option (here, the institution) has a potentially unfavorable (or neutral) outcome if the option is exercised. For example, the counterparty will exercise an option to sell securities to the institution at a specified price only when that price exceeds the current market prices. Accordingly, the institution must analyze such contracts carefully to understand the nature of the derivative and how it will work under various interest-rate and other conditions.

15.62 ***Other Variations.*** Other variations built into derivatives may require the institution to take certain actions or may result in changes in terms if specified events or conditions occur. For example, such variations might involve—

- Increases or decreases in the notional amount based on certain changes in interest rates.
- Increases or decreases in interest rates based on a multiplier.
- Additional payments required under specified conditions.
- A settlement payment required upon the expiration of a contract.

15.63 Some swap contracts magnify changes in the specified index rate by tying floating payments to an exponent of the index rate over a specified denominator. The risks of this variation are similar to the risks posed by written options. Consider a contract that specifies the floating rate as three-month LIBOR squared and divided by 5 percent. Assume that three-month LIBOR is 5 percent at inception. Were three-month LIBOR to climb five basis points to 5.05 percent, the increase would be magnified. The floating rate would increase ten basis points to approximately 5.10 percent (5.05 percent squared and divided by 5 percent). Thus, at this level of interest rates, an increase of one basis point in the index rate for the contract would result in an increase of two basis points in the contractual rate—in other words, one basis point on twice the stated notional amount.

15.64 Finally, the notional principal amount of certain swap contracts changes with changes in the rate to which the floating payments are indexed. These are called index amortizing swaps. For example, the notional principal amount may decrease when interest rates decline. Thus, the floating-rate payer would lose some of the benefit of declining interest rates but would not get a corresponding benefit if interest rates increase.

Regulatory Matters

15.65 Chapter 5 discusses the regulatory matters affecting the permissibility of certain investments.

15.66 Banking Circular (BC) 277, issued by the Office of the Comptroller of the Currency (OCC), addresses banks' risk management of derivatives and sets forth best practices and procedures for managing risk. OCC Bulletin 94-31 answers commonly asked questions about BC 277. The Board of Governors of the Federal Reserve System (FRB) issued detailed guidance to its examiners for evaluating derivatives with respect to management oversight, measurements and monitoring procedures, and internal controls. The Federal Deposit Insurance Corporation (FDIC) issued guidance for its examiners in Financial Institutions Letter (FIL) 34-94.

15.67 For regulatory financial reporting purposes, institutions regulated by the Office of Thrift Supervision (OTS) are permitted to follow GAAP as established in FASB Statement No. 80, *Accounting for Futures Contracts*, but the other agencies do not generally permit deferral of losses on futures and forward or standby contracts other than for futures and forward contracts used in mortgage banking operations.

Accounting and Financial Reporting

15.68 Authoritative pronouncements that establish accounting for derivatives generally involve consideration of (*a*) designation of derivatives as hedges, (*b*) effectiveness of the hedge strategy, and (*c*) the recognition and measurement of the instrument based on items (*a*) and (*b*). Although the accounting for futures and foreign currency forward contracts is fairly well-defined, the accounting for option, swap, and other forward contracts is more diverse and is continuing to evolve. Further, guidance does not exist for many customized instruments, and authoritative accounting literature that addresses hedge accounting is limited. The FASB's Emerging Issues Task Force (EITF) has dealt with a variety of issues related to certain derivatives, but not comprehensively.

15.69 The general guidelines for accounting for such financial instruments follow:

a. Funds deposited as margin should be reported as initial deposits, generally as other assets or liabilities. The payment or receipt of premiums should be reported as assets or liabilities. The notional amount or gross amount of assets deliverable under the contracts generally should not be reported in the balance sheet.

b. The financial instruments are marked to market with the resulting unrealized gains or losses recognized in earnings currently when—
   - The instrument is used for speculative purposes or for market making (in which case, the instrument should be included in the institution's trading account and the realized and unrealized gains or losses recognized as part of trading revenue).
   - The instrument represents a hedge of asset positions, contemplated asset positions, or short positions, all of which are, or will be, carried at market value.
   - The instrument is designated as a hedge but applicable criteria for hedge accounting are not met.

c. If hedging criteria are met, the objective of accounting for the instruments is to achieve symmetrical accounting between the hedging instrument and the hedged item (gains and losses either are reported currently or are deferred for both the hedging instrument and the hedged item, but the treatment is symmetrical for both components).[11] However, there are numerous hedge accounting issues that

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[11] Some institutions use such accounting for certain interest-rate swaps or forward rate agreements used in asset/liability management activities. The FASB has a project under way that could significantly change the way futures, forward, option, swap, and other similar financial contracts are recognized and measured. The project might also develop consistent and comprehensive standards for hedge accounting. A related FASB research report, *Hedge Accounting: An Exploratory Study of the Underlying Issues,* examines hedging in detail to identify and analyze the accounting issues that stem from those activities. Readers should be alert to any final pronouncements issued as a result of the financial instruments project.

have not been resolved in the accounting literature. Specified criteria are not defined for all financial instruments but risk reduction, designation, and effectiveness are common criteria.

15.70 These general rules apply to all of the financial instruments discussed below. The discussion of each specific instrument highlights any accounting pronouncements related to that instrument.

Foreign Currency Futures and Forwards

15.71 ***FASB Statement No. 52.*** FASB Statement No. 52, *Foreign Currency Translation,* provides guidance on accounting for forwards, futures, and swaps involving foreign currencies. Gains and losses on those foreign currency transactions are generally included in determining net income for the period in which exchange rates change unless the transaction hedges a foreign currency commitment or a net investment in a foreign entity. Contracts, transactions, or balances that meet FASB Statement No. 52's criteria as effective hedges of foreign exchange risk are accounted for as hedges without regard to their form. Specifically, paragraph 21 of FASB Statement No. 52 states, in part, that—

> A foreign currency transaction shall be considered a hedge of an identifiable foreign currency commitment provided both of the following conditions are met:
>
> *a.* The foreign currency transaction is designated as, and is effective as, a hedge of a foreign currency commitment.
>
> *b.* The foreign currency commitment is firm.

15.72 ***EITF Discussions.*** The EITF has discussed the following issues related to foreign currency forwards.[12]

- Issue No. 86-25, *Offsetting Foreign Currency Swaps,* addresses how the effect of a change in exchange rates on a foreign currency swap contract should be displayed in the balance sheet.
- Issue No. 87-2, *Net Present Value Method of Valuing Speculative Foreign Exchange Contracts,* addresses whether a discounting (or net present value) approach should be used in calculating the gain or loss on unsettled speculative foreign currency forward exchange contracts under FASB Statement No. 52.
- Issue No. 87-26, *Hedging of Foreign Currency Exposure with a Tandem Currency,* addresses whether a net investment in a foreign subsidiary may be hedged using a tandem currency (that is, a currency for which the exchange rate generally moves in tandem with the exchange rate for the exposed currency).
- Issue No. 88-18, *Sales of Future Revenues,* addresses certain transactions in which an institution receives cash from an investor and agrees to make certain payments to the investor based on future revenue or income denominated in a foreign currency
- Issue No. 91-1, *Hedging Intercompany Foreign Currency Risks,* addresses whether intercompany transactions present foreign exchange risk that may be hedged for accounting purposes, including whether

[12] See also Issue Nos. 90-17 and 91-4 in paragraph 15.82.

that conclusion would be affected by the type of hedging instrument used (for example, forward exchange contracts or purchased foreign currency options).

Futures and Forwards Other Than Foreign Currency Futures and Forwards

15.73 ***FASB Statement No. 80.*** FASB Statement No. 80 establishes standards of accounting for exchange-traded futures other than contracts for foreign currencies, which are addressed by FASB Statement No. 52.[13] FASB Statement No. 80 requires that a change in the market value of an open futures contract be recognized as a gain or loss in the period of the change unless the contract qualifies as a hedge of certain exposures to price or interest-rate risk. Immediate gain or loss recognition is also required by FASB Statement No. 80 if the futures contract is intended to hedge an item that is reported at fair value.

15.74 If the hedge criteria specified in FASB Statement No. 80 are met, a change in the market value of the futures contract is either reported as an adjustment of the carrying amount of the hedged item or included in the measurement of a qualifying subsequent transaction. FASB Statement No. 80 requires that entities cease accounting for a contract as a hedge if high correlation of changes in the market value of the futures contract and the effects of price or interest-rate changes on the hedged item has not occurred.

15.75 Hedge accounting under FASB Statement No. 80 differs from hedge accounting under FASB Statement No. 52 in three significant ways.

a. Paragraph 21(b) of FASB Statement No. 52 precludes a foreign currency transaction from being considered a hedge unless the foreign currency commitment is firm. Paragraph 9 of FASB Statement No. 80 permits hedge accounting for certain anticipated transactions without the existence of such a firm commitment.

b. The idea of risk reduction is applied in FASB Statement No. 52 at the transaction level but in FASB Statement No. 80 at the level of the institution's overall exposure to risk.

c. FASB Statement No. 80 permits cross-hedging.[14] FASB Statement No. 52 generally requires that the hedge instrument be denominated in the same currency as the item being hedged.

15.76 ***EITF Discussions.*** The EITF has discussed many issues related to forward and futures contracts, including the following.

- Issue No. 84-14, *Deferred Interest Rate Setting,* addresses accounting for deferred-interest-rate-setting arrangements.

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[13] Paragraph 34 of appendix C, "Background Information and Basis for Conclusions," of FASB Statement No. 80 says:

> Exclusion of forward contracts from the Statement should not be construed as either acceptance or rejection by the Board of current practice for such contracts, nor should the exclusion be interpreted as an indication that the general principles of this Statement might not be appropriate in some circumstances for certain forward contracts. At some future date, the Board may address the accounting for particular types of forward contracts, and it may address the conceptual aspects of accounting for executory contracts generally.

[14] Paragraph 4b of FASB Statement No. 80 says that:

> A futures contract for a commodity or a financial instrument different from the item intended to be hedged may qualify as a hedge provided there is a clear economic relationship between the prices of the two commodities or financial instruments, and provided high correlation is probable.

- Issue No. 85-6, *Futures Implementation Questions,* involves discussion of issues surrounding implementation of FASB Statement No. 80 that were subsequently addressed in the June 1985 issue of the FASB publication *Highlights.*
- Issue No. 86-26, *Using Forward Commitments as a Surrogate for Deferred Rate Setting,* involves a discussion of accounting for the change in value of a forward commitment entered into simultaneously with the issuance of fixed-rate debt.
- Issue No. 86-34, *Futures Contracts Used as Hedges of Anticipated Reverse Repurchase Transactions,* addresses accounting for such contracts.

Swaps

15.77 FASB Statement No. 52 addresses accounting for foreign currency swaps. There is no comprehensive guidance on accounting for noncurrency swaps. For swaps that are entered into to change the character of an interest-bearing asset or liability held in connection with asset/liability management (for example, from a fixed to a floating interest rate), interest income or expense for that asset or liability is reported using the revised interest rate, with any fees or other payments amortized as yield adjustments. Speculative contracts should be market to market.

15.78 ***EITF Discussions.*** EITF discussions of related swap issues include the following.

- Issue No. 84-7, *Termination of Interest Rate Swaps,* addresses recognition of gain or loss on the sale or the termination of an interest-rate swap.
- Issue No. 84-36, *Interest Rate Swap Transactions,* involves discussion of accounting for interest-rate swaps, including whether hedge criteria should apply and terminations. Related issues were subsequently addressed in the article "Interest Rate Swaps—Your Rate or Mine?" written by two FASB staff members, Keith Wishon and Lorin S. Chevalier, published in the September 1985 issue of the *Journal of Accountancy.*
- Issue No. 87-1, *Deferral Accounting for Cash Securities That Are Used to Hedge Rate or Price Risk,* addresses accounting for hedges of interest-rate swap portfolios using cash securities.
- Issue No. 88-8, *Mortgage Swaps,* addresses various issues related to the recognition and measurement of mortgage swaps.

Options and Other Option-Based Derivatives

15.79 There is no authoritative comprehensive accounting guidance for options and other option-based derivatives. Practice is somewhat diverse and controversial, especially in light of the differences between FASB Statements No. 52 and No. 80. AICPA Issues Paper No. 86-2, *Accounting for Options,* discusses options. However, the issues paper contains viewpoints that differ in certain respects from the conclusions in FASB Statements No. 52 and No. 80. The advisory conclusions expressed in the issues paper are not authoritative, and the FASB has advised that the existing authoritative accounting pronouncements should be followed.

15.80 FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* provides guidance on accounting for options (such as purchased equity options) that meet the definition of equity security in paragraph 137 and have a readily determinable fair value, as defined in paragraph 3 of FASB Statement No. 115.

15.81 In practice, accounting for options typically follows the general rules described in paragraph 15.69. Because of the nature of options, only purchased options are typically considered eligible for hedging treatment. Option writing is usually considered speculative and is accounted for as such. Therefore, the premium received for writing an option is marked to market. For purchased options considered hedges and accounted for on an accrual basis, gains or losses should be recorded in the appropriate period to match the timing of recognition of income or expense of the hedged item. The time value component of the premium paid for such purchased options is typically amortized over the life of the option while the intrinsic piece is considered part of the basis of the hedged exposure. The balance-sheet and income statement classifications should generally be the same as the balance-sheet positions being hedged.

15.82 ***EITF Discussions.*** EITF discussions of issues related to options and other option-based derivatives include the following.

- Issue No. 90-17, *Hedging Foreign Currency Risk with Purchased Options,* addresses the appropriateness of hedge accounting for purchased foreign currency options under various circumstances.
- Issue No. 91-4, *Hedging Foreign Currency Risks with Complex Options and Similar Transactions,* addresses the use of hedge accounting and disclosures for other purchased foreign currency options, written options, options purchased and written as a unit, and similar transactions.
- Issue No. 94-7, *Accounting for Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock,* addresses whether such instruments should be classified as assets, liabilities, or equity instruments and other related issues.

Financial Statement Presentation and Disclosure

15.83 In addition to the disclosure provisions of the pronouncements discussed elsewhere herein, several authoritative pronouncements directly set forth disclosure requirements.

15.84 ***FASB Statement No. 119.*** FASB Statement No. 119 requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. FASB Statement No. 119 also amended FASB Statements No. 105 and No. 107, *Disclosures about Fair Value of Financial Instruments*, to require such distinction in certain disclosures required by those statements.

15.85 For entities that hold or issue derivative financial instruments for trading purposes, FASB Statement No. 119 requires disclosure of average fair value and of net trading gains or losses. For entities that hold or issue derivative financial instruments for purposes other than trading, it requires disclosure about those purposes and about how the instruments are reported in financial statements. For entities that hold or issue derivative financial instruments and account for them as hedges of anticipated transactions, FASB Statement No. 119 requires disclosure about the anticipated transactions, the classes of derivative financial instruments used to hedge those transactions, the amounts of hedging gains and losses deferred, and the transactions or other events that result in recognition of the deferred gains or losses in earnings. FASB Statement No. 119 also encourages, but does not require, quantitative information about market risks of derivative financial instruments, and also of other assets and liabilities, that is consistent with the way the institution manages or adjusts risks and that is useful for comparing the results of applying the institution's strategies to its objectives for holding or issuing the derivative financial instruments.

15.86 ***FASB Statement No. 105.*** FASB Statement No. 105 establishes requirements for all entities to disclose information principally about financial instruments with off-balance-sheet risk of accounting loss. The Statement extended disclosure practices of some entities for some financial instruments by requiring all entities to disclose the following information about financial instruments with off-balance-sheet risk of accounting loss:

- The face, contract, or notional principal amount
- The nature and terms of the instruments and a discussion of their credit and market risk, cash requirements, and related accounting policies
- The accounting loss the institution would incur if any party to the financial instrument failed completely to perform according to the terms of the contract and the collateral or other security, if any, for the amount due proved to be of no value to the institution
- The institution's policy for requiring collateral or other security on financial instruments it accepts and a description of collateral on instruments presently held

15.87 FASB Statement No. 105 also requires disclosure of information about significant concentrations of credit risk from an individual counterparty or groups of counterparties for all financial instruments.

15.88 FASB Statement No. 119 amended FASB Statement No. 105 to require disaggregation of information about financial instruments with off-balance-sheet risk of accounting loss by class, business activity, risk, or other category that is consistent with the institution's management of those instruments.

15.89 ***FASB Statement No. 107.*** FASB Statement No. 107 extended fair value disclosure practices for some instruments by requiring all entities to disclose the fair value of financial instruments, both assets and liabilities recognized and not recognized in the statement of financial position, for which it is practicable to estimate fair value. If estimating fair value is not practicable, FASB Statement No. 107 requires disclosure of descriptive information pertinent to estimating the value of a financial instrument. Disclosures about fair value are not required for certain financial instruments. (See paragraph 8 of FASB Statement No. 107.)

15.90 Paragraph 11 of FASB Statement No. 107 requires that fair values be estimated for financial instruments with no quoted prices. Paragraph 24 of the Statement suggests that an estimate of the fair value of a customized interest-rate swap or foreign currency contract might be based on the quoted market price of a similar financial instrument (adjusted as appropriate for the effects of the tailoring) or, alternatively, on the estimated current replacement cost of that instrument. Paragraph 25 of the Statement suggests that an estimate of the fair value of customized options (for example, put and call options on stock, foreign currency, or interest-rate contracts) may be valued using one of a variety of pricing models that are used regularly to value options.

15.91 FASB Statement No. 119 amended FASB Statement No. 107 to require that fair value information be presented without combining, aggregating, or netting the fair value of derivative financial instruments with the fair value of nonderivative financial instruments and be presented together with the related carrying amounts in the body of the financial statements, a single footnote, or a summary table in a form that makes it clear whether the amounts represent assets or liabilities.[15]

Other Pronouncements

15.92 ***FASB Statement No. 115.*** Paragraph 115 of FASB Statement No. 115 discusses the effect that Statement may have on the accounting for derivatives that are hedges of securities whose accounting is changed by FASB Statement No. 115.

15.93 ***FASB Interpretation No. 39.*** Accounting Principles Board (APB) Opinion No. 10, *Omnibus Opinion—1966*, paragraph 7, says that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, defines *right of setoff* and specifies what conditions must be met to have that right. It also addresses the applicability of that general principle to forward, interest-rate swap, currency swap, option, and other conditional or exchange contracts and clarifies the circumstances in which it is appropriate to offset amounts recognized for those contracts in the statement of financial position. In addition, it permits offsetting of fair value amounts recognized for multiple forward, swap, option, and other conditional or exchange contracts executed with the same counterparty under a master netting arrangement. Appendix D-43 to the *EITF Abstracts* contains the FASB staff response to inquiries about the nature of support required for an assertion in financial statements that a right of setoff is enforceable at law.

15.94 ***FASB Statement No. 104.*** FASB Statement No. 104, *Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions,* amended FASB Statement No. 95, *Statement of Cash Flows,* to permit cash flows resulting from futures contracts, forward contracts, option contracts, or swap contracts that are accounted for as hedges of identifiable transactions or events to be classified in the same category as the cash flows from the items being hedged, provided that accounting policy is disclosed.

Auditing

Objectives

15.95 Financial statement assertions about derivatives activities are similar to assertions for other transactions—completeness, existence, valuation,

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[15] The FASB has issued a related special report, *Illustrations of Financial Instruments Disclosures*.

ownership, and disclosure. But because the notional or contractual amounts for derivatives generally are not recognized in the statement of financial position (that is, they are off-balance-sheet), the approach to achieving audit objectives may differ. Objectives of audit procedures for derivatives transactions might include those designed to test that—

a. Derivatives contracts have been executed and processed according to management's authorizations.

b. Income on derivatives, including premiums and discounts, is properly measured and recorded.

c. Derivatives accounted for as hedges meet the applicable criteria for hedge accounting.

d. Changes in the market value of derivatives have been appropriately accounted for in the circumstances (whether or not hedge accounting is used).

e. Information about derivatives in the financial statements is complete and has been properly classified, described, and disclosed.

15.96 The independent accountant, as a result of testing derivatives transactions, should evaluate the results in the context of the institution's financial statements as a whole. Statement on Auditing Standards (SAS) No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), provides guidance on the evaluation of audit test results. Paragraph 14 of SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), and paragraph 29 of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), discuss further that the independent accountant is to evaluate the reasonableness of estimates in relationship to the financial statements taken as a whole.

Planning

15.97 As discussed in this chapter, derivatives may be complex and volatile, and it is sometimes difficult to understand their features, risks, and intended uses. Further, accounting issues involving derivatives can be contentious. Also, management's intentions may affect the applicable accounting. Instruments' reported financial statement amounts may involve accounting estimates that are based on subjective factors. Those matters may increase audit risk in audits of the financial statements of banks and savings institutions that use derivatives.

15.98 ***Learning About the Extent of Derivatives Use.*** SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), addresses the considerations and procedures involved in planning and supervising financial statement audits, including preparation of an audit program and obtaining knowledge of the institution's business. SAS No. 22 recognizes that the nature, timing, and extent of planning vary with the size and complexity of the institution whose financial statements are being audited, as well as with the independent accountant's experience with the institution and knowledge of the institution's business.

15.99 A key question for addressing the audit of derivatives is whether (and to what extent) the institution engages in derivatives activities. One source of information to consider would be past derivatives activities. However, entrance into derivatives markets by a particular institution may be recent. Accordingly, the absence of past derivatives activities by an institution may not be a reliable indicator of whether the institution currently engages in such derivatives activities. In general, a good starting point would be to gather information about the nature and extent of an institution's derivatives through direct inquiry of management, particularly those in the treasury or finance function. It may also be helpful, when planning in this area, to review minutes of the board of directors or its audit, finance, or other committees, and reports prepared by the institution's internal audit function that address an institution's treasury or finance function. Review of activity in typical transaction accounts (for example, investments) and inspection of actual contracts may also be helpful. Interim financial statements, regulatory financial reports, and regulatory examination reports may be additional sources of information in this area.

15.100 Depending on the extent of derivatives activities, the independent accountant may decide to involve in the audit process personnel knowledgeable about derivatives. After assessing risk, the independent accountant may decide also that it is necessary to use the work of specialists.

15.101 ***Assessing Risk.*** Once the independent accountant has gathered information about the nature and extent of derivatives activities, such information can be used in assessing audit risk and otherwise carrying out the engagement in accordance with generally accepted auditing standards (GAAS). Audit risk is defined in SAS No. 47 as "the risk that the independent accountant may unknowingly fail to appropriately modify his [or her] opinion on financial statements that are materially misstated." SAS No. 47 explains that audit risk and materiality are considered with other matters in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures. SAS No. 47 further describes audit risk as the product of three component risks:[16]

a. *Inherent risk* involves the susceptibility of an assertion to a material misstatement in the absence of internal controls.

b. *Control risk* is the risk that a material misstatement will not be prevented or detected by internal controls.

c. *Detection risk* is the risk that the independent accountant will not detect a material misstatement.

15.102 Further, factors such as the following may indicate higher than normal audit risk:

- Sudden or rapid growth in derivatives activities
- Significant use of derivatives without relevant expertise within the institution
- High volatility in interest rates, currencies, or other factors affecting the values of derivatives
- Inclusion of embedded options or other complex contractual terms
- Uncertainty regarding the financial stability of a counterparty
- Concentrations of credit risk with one counterparty

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[16] Paragraphs 15.03 through 15.08 may be helpful to the independent accountant in assessing audit risk associated with derivatives.

- Transactions involving derivatives having thin markets
- Large one-time transactions
- Little involvement by senior management or the board of directors in authorization of significant derivatives activities
- Absence of authorized limits for derivatives activities or noncompliance with such limits
- Failure to adequately segregate duties involving the execution of derivatives transactions from the accounting and internal audit functions
- Dependence on one individual for all organizational expertise on derivatives activities
- Inadequate information to effectively monitor derivatives transactions, including inadequate or untimely information about derivatives values

Of course, these factors should be considered in the context of the complexity and extent of the institution's derivatives activities and the institution's financial statements taken as a whole.

Internal Control Structure Over Financial Reporting and Possible Tests of Controls

15.103 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent accountant's consideration of an institution's internal control structure in an audit of financial statements performed in accordance with GAAS.[17] It describes the elements of an internal control structure and explains how an independent accountant should consider the internal control structure in planning and performing an audit. SAS No. 55 requires that, in all audits, the independent accountant obtain sufficient understanding of each of the three elements (the control environment, accounting system, and control procedures) to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

15.104 The level of sophistication of an institution's internal control structure as it relates to derivatives activities generally varies. Determinants include the extent of the institution's use of derivatives and the relative complexity of the instruments used. An effective internal control structure over financial reporting of derivatives transactions generally would include ade-

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[17] In December 1995, the Auditing Standards Board (ASB) issued SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol.1, AU sec. 319). SAS No. 78 revises the definition and description of internal control contained in the SASs to recognize the definition and description contained in *Internal Control—Integrated Framework* published by the Committee of Sponsoring Organizations of the Treadway Commission. SAS No. 78 is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted.

In conjunction with SAS No. 78, the ASB issued Statement on Standards for Attestation Engagements (SSAE) No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2* (AICPA, *Professional Standards*, vol. 1, AT sec. 400). SSAE No. 6 conforms the description of elements of an entity's internal control to the components of internal control contained in SAS No. 78 and the *Internal Control—Integrated Framework*. SSAE No. 6 is effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, with earlier application permitted.

quate segregation of duties, management oversight, and other policies and procedures designed to reasonably assure that—[18]

- Derivatives transactions are executed in accordance with the institution's written policies (as approved by the board of directors or its committees).
- Information relating to derivatives is complete and accurate when entered into the accounting system.
- Misstatements in the processing of accounting information for derivatives are prevented or detected in a timely manner.
- Derivatives activities are monitored on an ongoing basis to recognize and measure events affecting related financial statement assertions.

15.105 If the nature of the institution's derivatives use is considered to involve more than normal risk, the independent accountant may decide to assess control risk at the maximum level and take a primarily substantive approach.[19]

15.106 The independent accountant may consider applying procedures such as inquiry, observation, and inspection of documents to obtain an understanding of internal control policies and procedures. Ultimately, the independent accountant must decide on the nature, timing and extent of substantive tests to be applied.

Substantive Tests

15.107 Many derivatives are negotiated contracts between the institution and its counterparty (for example, most interest-rate swaps). Because such transactions usually are not routine, a substantive audit approach may be the most effective means of achieving the planned audit objectives. Procedures performed in other financial statement areas might also provide evidence about the completeness of derivatives transactions. These procedures may include tests of subsequent cash receipts and payments, cutoff bank statements, and the search for unrecorded liabilities. Examples of other substantive procedures that may be applied specifically to derivatives transactions are illustrated below. The independent accountant is responsible for determining the extent of substantive testing considered necessary, based on the nature and significance of the related transactions and the assessment of audit risk. SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), provides guidance on evaluating evidential matter and relating it to assertions in an institution's financial statements.

15.108 ***Propriety of Accounting.*** A primary audit objective usually addressed through substantive procedures is determining the propriety of the institution's accounting for derivatives. To do so, the independent accountant gains an understanding of management's objectives in engaging in derivatives transactions. For derivatives accounted for as hedges, the independent accountant

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[18] Inadequate or deficient controls should be considered in the context of SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 60 provides guidance on identifying and reporting conditions that relate to an institution's internal control structure over financial reporting observed during an audit of financial statements in accordance with GAAS.

[19] Although the independent accountant may be able to assess internal control risk as low (thereby modifying the nature, timing, or extent of substantive testing considered necessary) derivatives transactions often are not homogeneous. It may be more efficient and effective to adopt a primarily substantive approach. Such an approach may be particularly efficient where the number of contracts or transactions is few.

generally tests whether the applicable hedging criteria are met. This might include tests of the institution's documentation of correlation results and determining that the institution is appropriately distinguishing between speculating and hedging. The independent accountant also may examine support for completed transactions to ascertain that they have been accounted for appropriately. For example, the independent accountant might review transactions that resulted in deferrals of losses during the period to determine whether they qualified for deferral accounting. Similarly, the independent accountant might review gains recognized during the period to determine whether they were hedging gains that should have been deferred.

15.109 ***Review of Contracts.*** If the institution's derivatives are not exchange-traded or otherwise standardized, the independent accountant may consider inspecting the contracts and related transactions tickets to understand the terms of the transaction. Developing an understanding of the contract terms by reading the contract might include identifying nonstandard features, such as the existence of embedded options. Nonstandard features may significantly increase the risks and complexities of the transactions and may involve potential accounting and disclosure consequences.

15.110 ***Analytical Procedures.*** SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), provides guidance on the use of analytical procedures in the planning and review stages of audit engagements. Analytical procedures might also be effectively used as a substantive test to obtain evidential matter about particular assertions related to derivatives transactions.

15.111 ***Confirmation.*** SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), discusses the relationship of confirmation procedures to the assessment of audit risk, the design of confirmation requests, the performance of alternative procedures, and the evaluation of confirmation results. Guidance on the extent and timing of confirmation procedures is found in SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350), SAS No. 47, and SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AICPA, *Professional Standards*, vol. 1, AU sec. 313, "Substantive Tests Prior to the Balance Sheet Date").

15.112 ***Other Tests.*** Other tests the independent accountant may perform include the following:

- Test the mathematical accuracy of the institution's accounting records, including the amortization of deferred gains and losses on financial instruments accounted for as hedges and of unearned fee income.
- Examine support for completed transactions to ascertain that they have been accounted for appropriately and in the proper period.
- Verify computations and rates used for realized gains and losses during the period.
- Review exposure to individual counterparties and consider the need to evaluate individual credit risk and review overall liquidity position.

15.113 ***Auditing Fair Values and Other Estimates.*** SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance on auditing accounting estimates (such as estimates of fair values). SAS No. 57 discusses how an independent accountant obtains an understanding of how management developed estimates, concentrating on the key factors and assumptions used. It also discusses how the independent accountant may review and test the process used by management to develop an estimate.

15.114 The fair value of certain derivatives, such as exchange-traded options, is generally readily available from independent pricing sources. Such sources include financial publications or brokers and dealers independent of the institution. Determining the fair value of other derivatives can be difficult, however, particularly where the transaction has been customized for an institution. Calculation of the fair value of customized interest-rate swaps, for example, may require various quantitative assumptions and complex mathematical modeling. Calculations of such fair values also are complicated by subjective value considerations that depend on the specifics of the transaction (such as the credit risk associated with a specific counterparties). Complex valuation models also involve the risk of errors in either data entry or assumptions or that the model is not appropriately designed or tested. The independent accountant might consider it necessary to involve specialists in assessing the institution's fair value estimates or related models. SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), provides guidance on using the work of a specialist. As described in paragraph 3, the guidance of SAS No. 73 applies when an independent accountant uses a specialist's work as evidential matter in performing substantive tests to evaluate material financial statement assertions.

Chapter 16

Business Combinations

Introduction

16.01 Business combinations may involve one enterprise acquiring the equity interests or net assets of another enterprise or both enterprises transferring their equity interests or net assets to a newly formed enterprise. Business combinations involving depository institutions are increasingly common today and result from voluntary decisions as well as regulatory mandates. Most business combination issues, such as distinguishing between whether a business combination should be treated as a purchase or a pooling of interests, are the same for depository institutions as for other business enterprises. This chapter addresses only significant issues that are unique to depository institutions.

Regulatory Matters

16.02 The Office of Thrift Supervision (OTS) requires the independent accountants for both the purchasing and selling institutions to opine on whether the transaction has been accounted for in conformity with generally accepted accounting principles (GAAP).

16.03 In certain circumstances, an acquired bank or savings institution uses the acquiring institution's basis of accounting in preparing the acquired institution's financial statements. These circumstances are addressed for Securities and Exchange Commission (SEC) registrants in the SEC's Staff Accounting Bulletin (SAB) No. 54, *Application of "Push Down" Basis of Accounting in Financial Statements of Subsidiaries Acquired by Purchase.* In the Financial Accounting Standards Board's (FASB's) Emerging Issues Task Force (EITF) Issue No. 86-9, *IRC Section 338 and Push-Down Accounting*, the EITF reached a consensus that such push-down accounting is not required for companies that are not SEC registrants. However, push-down accounting is required by the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Board of Governors of the Federal Reserve System (FRB) when there is at least a 95 percent change in ownership and by the OTS when there is at least a 90 percent change in ownership.

16.04 The SEC's SAB No. 82, *Certain Transfers of Nonperforming Assets: Disclosures of the Impact of Assistance from Federal Regulatory Agencies*, discusses accounting for transfers of nonperforming assets by financial institutions and disclosure of the impact of financial assistance from regulators. SAB No. 82 states the SEC staff's belief that users of financial statements must be able to assess the impact of credit and other risks on a company following a regulatory-assisted acquisition, transfer, or other reorganization on a basis comparable with that disclosed by other institutions, that is, as if the assistance did not exist. In that regard, the SEC staff believes that the amount of regulatory assistance should be separately disclosed and should be separately identified in the statistical information furnished pursuant to Industry Guide 3, *Statistical Disclosures by Bank Holding Companies*, to the extent that it affects such information. Further, the nature, extent, and impact of such assistance should be fully disclosed in management's discussion and analysis.

Accounting and Financial Reporting

16.05 Accounting for business combinations involving depository institutions is similar to that for other enterprises. Guidance on accounting for business combinations and related issues is contained in the following:

a. Accounting Principles Board (APB) Opinion No. 16, *Business Combinations,* and *Business Combinations: Accounting Interpretations of APB Opinion No. 16*

b. APB Opinion No. 17, *Intangible Assets*

c. FASB Statement of Financial Accounting Standards No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*

d. FASB Statement No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions*

e. FASB Statement No. 109, *Accounting for Income Taxes*

f. FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*

g. FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*

h. FASB Interpretation No. 9, *Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method*

i. FASB Technical Bulletin No. 85-5, *Issues Relating to Accounting for Business Combinations*

j. AICPA Practice Bulletin 6, *Amortization of Discounts on Certain Acquired Loans* (See paragraph 5.76.)

k. EITF Issue No. 86-31, *Reporting the Tax Implications of a Pooling of a Bank and a Savings and Loan Association*

l. EITF Issue No. 87-15, *Effect of a Standstill Agreement on Pooling-of-Interests Accounting*

m. EITF Issue No. 87-16, *Whether the 90 Percent Test for a Pooling of Interests Is Applied Separately to Each Company or on a Combined Basis*

n. EITF Issue No. 87-27, *Poolings of Companies That Do Not Have a Controlling Class of Common Stock*

o. EITF Issue No. 88-19, *FSLIC-Assisted Acquisitions of Thrifts*

p. EITF Issue No. 88-26, *Controlling Preferred Stock in a Pooling of Interests*

q. EITF Issue No. 88-27, *Effect of Unallocated Shares in an Employee Stock Ownership Plan on Accounting for Business Combinations*

r. EITF Issue No. 89-19, *Accounting for a Change in Goodwill Amortization for Business Combinations Initiated Prior to the Effective Date of FASB Statement No. 72*

s. EITF Issue No. 90-5, *Exchanges of Ownership Interests between Entities under Common Control*

t. EITF Issue No. 93-2, *Effect of Acquisition of Employer Shares for / by an Employee Benefit Trust on Accounting for Business Combinations*

u. EITF Issue No. 93-7, *Uncertainties Related to Income Taxes in a Purchase Business Combination* *v.* EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*

w. EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*

x. EITF Issue No. 95-8, *Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination*

16.06 In business combinations accounted for under the purchase method, the assets and liabilities of the acquired business are recorded on the books of the combined institution at their fair value at the time of acquisition. The cost of the acquisition is allocated to identifiable tangible and intangible assets and liabilities being acquired or assumed, with any excess cost recorded as an unidentifiable intangible (goodwill). For assets and liabilities acquired for which there is not an active market, determining fair values usually involves estimating cash flows and discounting those cash flows at prevailing market rates of interest. Demand deposits are valued at their face amount plus any accrued interest. Practice Bulletin 6 provides guidance as to the accounting and reporting by purchasers of certain loans for which it is not probable that the undiscounted future cash collections will be sufficient to recover the face amount of the loan and contractual interest. Paragraph 14 of FASB Statement No. 114 provides guidance as to the determination of the effective interest rate when loans are acquired at a discount because of a change in credit quality or rate, or both. APB Opinion No. 17 establishes the accounting for both identifiable and unidentifiable intangible assets that a company acquires, including those acquired in business combinations. FASB Statement No. 72 amended APB Opinion No. 17 with regard to the amortization of unidentifiable intangible asset (goodwill) recognized in certain business combinations accounted for by the purchase method.

Identifiable Intangible Assets

16.07 FASB Statement No. 72 states that, in combinations accounted for by the purchase method involving the acquisition of a bank or savings institution, intangible assets acquired that can be separately identified should be assigned a portion of the total cost of the acquired enterprise if the fair values of those assets can be reliably determined (paragraph 4). Such assets should not be included as part of unidentifiable intangible assets (goodwill). The fair value of such assets shall be based on customer relationships that exist at the date of acquisition without regard to new customers that may replace them. In determining those values, the acquiring bank should consider the capacity of existing deposit accounts and loan accounts to generate future income and to generate additional business or new business and the nature of territory served. Examples of other identifiable intangible assets common to depository institution acquisitions include purchased credit-card relationships, core deposit relationships, favorable leaseholds, and trust servicing. (Chapter 10 on other assets addresses amortization of intangible assets.)

Unidentified Intangible Assets

16.08 In a purchase business combination, the excess of the purchase price over the fair value of the net assets acquired, including identifiable intangible assets, is recorded as goodwill. Paragraph 2 of FASB Statement No. 72 says:

> Paragraphs 5 and 6 [of FASB Statement No. 72] apply to only those acquisitions in which the fair value of liabilities assumed by the acquiring enterprise exceeds the fair value of tangible and identifiable intangible assets acquired, and those provisions specify an amortization method for the portion of any unidentifiable intangible asset up to the amount of that excess. [APB Opinion No. 17 and FASB Interpretation No. 9] also provide guidance as to the amortization of any additional unidentifiable intangible asset recognized in the acquisition.

Intangible assets arising from purchase business combinations are generally included in other assets and amortized over the period for which they have value. (Chapter 10 on other assets addresses amortization of intangible assets.)

Negative Goodwill

16.09 If the fair value of net assets acquired exceeds the purchase price, the cost of noncurrent assets acquired (except long-term investments in marketable securities), such as bank premises and equipment and intangible assets, should be adjusted downward on a pro rata basis. Negative goodwill should be recorded only after the costs of such assets received in the acquisition have been adjusted to zero.

Branch Acquisitions

16.10 Depository institutions may acquire branch office locations. Such transactions typically involve the assumption of deposit liabilities by the acquiring institution in exchange for the receipt of a lesser amount of cash, or other assets, such as loans. The buying institution should account for such transactions based on the fair values of the assets acquired and liabilities assumed. The selling institution generally recognizes a gain or loss on such a transaction based on the proceeds from the transaction, the recorded amounts of the deposit liabilities assumed by the purchaser, and the recorded value of assets conveyed to fund the purchase.

16.11 The acquiring institution should account for specifically identifiable assets, liabilities and goodwill arising from the transaction in conformity with APB Opinion No. 16 and FASB Interpretation No. 9. FASB Statement No. 72 provides guidance on how to amortize unidentifiable intangible assets (goodwill) recorded in the purchase. (See paragraph 16.08.)

Regulator-Assisted Transactions

16.12 The FDIC sometimes provides financial assistance to depository institutions to facilitate a purchase transaction. The kinds of assistance vary but may include *(a)* put-back rights, which represent the option to return certain acquired assets, *(b)* purchase options, which represent the right to acquire certain assets at specified terms, *(c)* cash or notes to the extent that liabilities assumed exceed assets acquired, *(d)* yield-maintenance assistance on specified assets, *(e)* purchase of equity securities, or *(f)* indemnification against certain loss contingencies.

16.13 FASB Statement No. 72 specifies that financial assistance granted to an enterprise by a regulatory authority in connection with a business combination shall be accounted for as part of the combination if receipt of the assistance is probable and the amount is reasonably estimable. If it is not probable or estimable, the future proceeds from such assistance should be reported as a reduction of goodwill when received. In such a case, subsequent amortization of goodwill would be adjusted proportionately.

16.14 EITF Issue No. 88-19 addresses situations in which a savings institution is acquired pursuant to an assistance agreement (agreement) between the acquirer and the Federal Savings and Loan Insurance Corporation (FSLIC). Since the date of the consensus, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) dissolved the FSLIC; however, the consensus still applies to regulatory-assisted acquisitions. Under the agreement, the acquirer may receive a note receivable from the government regulator that typically equals the amount by which the fair value of the institution's liabilities exceeds the fair value of its assets or other assistance described in paragraph 16.09. In addition, the acquirer may infuse into the institution additional capital that, with the government assistance, is expected to make the institution a viable entity.

16.15 Under the terms of the agreement, the government may be entitled to share in certain tax benefits that may be realized subsequently by the institution. A tax-sharing arrangement with the government in which the government is entitled to share in a specified percentage (up to 100 percent) of certain income tax benefits that are realized by the institution should be offset against the income tax benefits realized by the thrift, and the net tax benefit should be accounted for in accordance with GAAP for income taxes. This is based on the view that the institution is merely a conduit for the tax benefits accruing to the government.

16.16 The acquirer should account for assistance in the form of yield maintenance on covered assets until those assets are disposed of or liquidated. Assets covered by yield-maintenance assistance should be considered interest-bearing assets for purposes of applying FASB Statement No. 72, even if the covered assets are non-interest-bearing. This applies only to regulatory-assisted combinations covered by FASB Statement No. 72. A consequence of considering certain non-interest-bearing assets as interest-bearing assets is that those non-interest-bearing assets will affect the period over which goodwill is amortized in accordance with paragraph 5 of FASB Statement No. 72.

16.17 When allocating the purchase price, the acquirer must determine what interest rate should be used to determine the fair value of assets covered by yield-maintenance assistance. There is a rebuttable presumption that the stated interest rate (the guaranteed yield or level of return on covered assets) specified in the agreement should be considered a market rate for purposes of determining the fair value of the assets acquired. If the presumption is rebutted, the acquirer should select a market rate in accordance with paragraph 88 of APB Opinion No. 16.

16.18 No net change in the basis of the asset should be recognized if an asset covered by yield-maintenance assistance is converted to a different covered asset (for example, if land held for development is sold to an unrelated third party in exchange for a note receivable).

16.19 EITF Issue No. 88-19 also addresses how the acquirer should account for contingency losses and for the reimbursement of those losses by the government under the indemnification provisions of the agreement (including losses and reimbursements that occur after the expiration of the purchase-price allocation period). Losses resulting from acquisition-related contingencies that are covered by the indemnification provisions of the agreement should be recognized by the acquirer net of reimbursements received or receivable from the government under the agreement.

16.20 If part of the government assistance involves a note receivable from the government, and equity securities of the institution are sold to the government for cash or other consideration, there is a rebuttable presumption that consideration paid by the government for equity securities is not separable from a note receivable from the government for other assistance. Therefore, when part of the government assistance involves a note receivable from the government, a portion of the note receivable equal to the fair value of the equity securities sold to the government should be offset against the equity securities. Issuance of the equity securities to the government may be separately reported as an increase in equity only if it can be demonstrated that the equity security is economically separable from the note receivable from the government. Economic separability may be demonstrated only if all of the following conditions are met:

a. The regulator acquires equity securities for cash at the same per-share price as other shareholders, and the securities are identical in all substantive respects (except for voting rights) to those issued to other shareholders.

b. The portion of stock acquired by the regulator is less than 20 percent of the outstanding stock.

c. The dividend requirements on the stock held by the regulator are the same as those on the stock held by others.

d. The dividend terms of the equity securities do not match and offset the principal and interest terms of the note receivable.

e. Repayment of principal and interest on the note is due independently of dividend or redemption payments.

f. The interest rate stated in the note receivable from the regulator is a market rate.

g. The stock cannot be put back to the institution by the regulator (however, callable stock is acceptable).

16.21 If all or a portion of the note receivable from the government is offset against the equity from the securities issued to the government, then subsequent dividend payments to the government on the equity securities should be netted against cash receipts from the government for interest payments on the note, and the net amount should be recorded as regulatory assistance, as appropriate.

Conversion and Merger-Conversion Transactions

16.22 The conversion of a mutual or cooperative enterprise to stock ownership generally does not constitute a change in equity interests that would preclude pooling-of-interests accounting for two years. In accordance with paragraphs 21 through 24 of FASB Technical Bulletin No. 85-5, an exception to the change-in-equity-interests condition is allowed for mutual or cooperative enterprises that convert to stock ownership, because the conversion represents a change in the form of organization rather than a change in equity interests from one group of equity owners to another.

16.23 In some cases, shares of the former mutual or cooperative enterprise may be acquired by the other prospective combining enterprise in the conversion of the mutual or cooperative enterprise to stock ownership prior to effecting the combination. In that situation, those shares would be subject to the 10 percent test under the independence condition and the 90 percent test under the common-stock-for-common-stock condition in determining whether pooling-of-interests accounting should be applied to the subsequent business combination.

16.24 In certain merger-conversion transactions involving savings institutions, a mutual savings institution is converted to stock ownership, shares of the new stock savings institution are exchanged for shares of the issuing enterprise in the combination, and those shares of the issuing enterprise are offered first to depositors in the former mutual savings institution and then to the public. The pooling criteria are applied to the merger between the new stock savings institution and the issuing enterprise. Assuming all other pooling conditions are met, such a merger conversion does not violate the pooling conditions. In other merger-conversion transactions, as well as those transactions previously discussed, the issuing enterprise in the combination may purchase shares of its common stock issued in the combination that are not purchased by depositors in the former mutual savings institution rather than offer those shares to the public. The purchase by the issuing enterprise of less than ten percent of the shares issued to effect the combination (reduced for any other pooling violations) does not violate the pooling conditions in this situation, provided that the depositors of the former mutual savings institution are given the opportunity to acquire all of the shares issued to effect the combination and that the issuing enterprise purchases only those shares not purchased by the depositors. However, pooling-of-interests accounting is not appropriate if limitations or restrictions are placed on the depositors' rights to acquire the shares issued to effect the combination. In addition, pooling-of-interests accounting is not appropriate if regulators have required either enterprise to enter into the combination or if regulators provided financial assistance to facilitate the combination.

Auditing

Objectives

16.25 The primary objectives of audit procedures for business combinations are to obtain reasonable assurance that—

a. The transaction is properly accounted for using the pooling-of-interests or purchase methods.

b. The values assigned to the assets and liabilities of the acquired institution in a purchase business combination represent the fair values at the date of acquisition.

c. Any identifiable intangible assets or goodwill arising from a purchase accounting transaction are identified and amortized over an appropriate period of time.

d. Any regulatory assistance received to facilitate the purchase is appropriately accounted for and disclosed.

Internal Control Structure Over Financial Reporting and Possible Tests of Controls

16.26 Typical internal control policies and procedures relating to financial reporting of business combinations include the following:

- Accounting entries made to record the transaction initially and those required in subsequent years including values assigned are adequately supported and reviewed by supervisory personnel to ensure accuracy.
- Values assigned to the assets and liabilities of the acquired institution are reviewed by management.

- Subsequent to the acquisition date, assumptions used in assigning values to assets and liabilities are reviewed by management for continuing validity.

Substantive Tests

16.27 The nature, timing, and extent of substantive procedures should be determined based on the independent accountant's understanding of the internal control structure surrounding business combinations and consolidations and the assessment of control risk in this area. Usually the independent accountant assesses control risk at the maximum and plans a substantive approach to the examination of business combinations in the year of acquisition and the period of subsequent combination of the operations of the entities.

16.28 For significant transactions accounted for as poolings of interests, the independent accountant should perform procedures to determine that the conditions for the pooling of interests method of accounting have been met.

16.29 The independent accountant should perform tests to obtain assurance regarding the fair values assigned to an acquired depository institution's or branch's assets and liabilities, which are generally supported by independent third-party appraisals. Statement on Auditing Standards (SAS) No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), provides guidance on the independent accountant's consideration in using the work of specialists such as appraisers. The independent accountant should consider the need for asking management to engage appraisers to determine the propriety of any significant assigned carrying values that are unsupported by independent appraisals. (Chapter 9 discusses the use of real estate appraisals.)

16.30 The independent accountant should evaluate whether the assumptions used in independent appraisals are reasonable, and particular attention should be focused on assumptions concerning the assessment of credit risk, loan prepayment factors, and the interest rate assigned in relation to current market conditions.

16.31 In applying procedures to a branch purchase, the independent accountant should be satisfied with the documentation supporting the fair values assigned to the deposit liabilities assumed and the assets acquired.

Chapter 17

Trust Services and Activities

Introduction

17.01 Among other engagements, independent accountants may be engaged to (*a*) report on trust company financial statements, particularly of common trust or mutual funds, (*b*) assist with directors' examinations of trust financial information,[1] or (*c*) report on the internal control structure over financial reporting in the institution's trust department.[2] However, this chapter deals primarily with how trust services and activities affect audits of the financial statements of banks or savings institutions.

17.02 Trust services and activities consist of the fiduciary services provided to customers. A fiduciary may be a trustee or an agent. Trust activities of an institution may be an integral part of the institution's services; however, because of strict laws governing fiduciary responsibilities, institutions conduct trust activities independently through[3]—

a. A separate department or division of the institution.

b. A separately chartered trust company.

c. A contractual arrangement with the trust department or a trust company of another depository institution.

17.03 The organizational structures of institutions' trust departments or of trust companies vary greatly depending upon factors such as the scope of trust activities, the complexity of trust services offered, management's preference, and the historical development of the entity. Trust organizations vary from small operations with one person devoted to trust activities on a part-time basis to large organizations with a variety of specialized staff such as tax attorneys, employee benefit specialists, and investment specialists.

17.04 Trusts can be broadly categorized as personal, corporate, or employee benefit.

Personal Trusts

17.05 Personal trust accounts may be established for individuals or other entities such as foundations, college endowments, and not-for-profit organizations. A brief description of the primary kinds of personal trusts follows.

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[1] See paragraph A-39 in appendix A.

[2] Usually, such an engagement is the result of the need of auditors of the financial statements of pension plans, mutual funds, and other entities to obtain evidential matter regarding the internal control structure in the departments of a bank or savings institution controlling assets of other entities. Since an institution may administer many plans, it may not be economically feasible for each plan's independent accountant to carry out audit procedures at the trustee institution. Accordingly, one independent accountant may perform procedures in the area or department administering all plans at the institution and issue a report to the user institution on internal accounting controls related to administration of the plans. Statement on Auditing Standards (SAS) No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), and Statement on Standards for Attestation Engagements (SSAE) No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting*, (AICPA, *Professional Standards*, vol. 1, AT sec. 400), provide guidance for such engagements.

[3] Most notably, Title 12 of the Code of Federal Regulations (12 CFR), Parts 9.9 (OCC) and 550.7 (OTS); state fiduciary laws often provide additional requirements.

a. *Testamentary trusts* are created under a will. Administrative responsibility begins when assets are transferred from the estate to the trust. Almost all testamentary trusts are irrevocable.

b. *Voluntary trusts* (*inter vivos*), also referred to as *living trusts*, are established by individuals during their lifetimes. This type of trust is often established with powers of revocation or amendment. Furthermore, it has been increasingly common for the grantor of the trust to retain the power to control or participate in deciding on investments resulting in a self-directed trust.

c. *Court trusts* are trusts in which the trustee is accountable to a court. Court trusts generally include decedents' estates (under which the courts appoint administrator institutions to settle the estates of persons who either died without leaving wills or who nominated the institutions as executors in their wills), guardianships, and some testamentary trusts.

d. *Agency agreements* provide for the care of other parties' securities and properties. Safekeeping and custodianship agreements are two of the more common types.

e. *Property management agreements* provide for the management of property, for example, real estate or securities investments, by the trustee institution. The institution, as agent, has managerial duties and responsibilities appropriate to the kind of property being managed. (Such agreements also may exist for employee benefit trusts.)

17.06 Closely held business management responsibilities may arise through the normal course of events when an institution serves as trustee of a personal trust (or employee benefit trust) that holds ownership of the enterprise, through involvement in winding down the affairs of an estate, or through a specialized property management agreement.

Corporate Trusts

17.07 A brief description of the primary kinds of corporate trust activities follows.

a. As *transfer agent*, the trust department or trust company transfers registered (in contrast to bearer) securities from one owner to another and maintains the records of ownership.

b. As *registrar*, the trust department or trust company maintains for corporations control over the number of shares issued and outstanding.

c. As *joint registrar-transfer agent*, the trust department or trust company acts jointly as registrar and transfer agent for the same issue.

d. As *paying agent*, the trust department or trust company distributes interest or dividend payments or redeems bonds and bond coupons of corporations and political subdivisions within the terms of an agency agreement.

e. When an institution is a *trustee under indenture*, the trust department or trust company acts as an agent designated by a municipality, corporation, or other entity to administer specified cash receipt or payment functions. The trust department or trust company performs the duties specified in the agreement, which might include holding collateral; issuing bond instruments; maintaining required records, accounts and documentation; monitoring for default; ensuring legal compliance; and effecting the payment of principal and interest.

Employee Benefit Trusts

17.08 In recent years, the employee benefit trust has become a common arrangement to handle the investment of assets of employee benefit plans and the disbursement of plan assets for payments of benefits to participants. Usually employee benefit trusts are utilized in connection with employee benefit plans governed by the Employee Retirement Income and Security Act of 1974 (ERISA), the federal law dealing with employee benefit plans. A brief description of the primary kinds of employee benefit trusts follows.

a. *Pension or profit-sharing trusts* provide for a trustee institution to manage trust funds established for the benefit of eligible company officers or employees or for members of a union, professional organization, or association. Such trusts are established by comprehensive written plans in which the trustees' powers are limited and their duties are well defined. These trusts may exist in connection with a variety of types of benefit plans, including defined benefit plans, defined contribution plans, individual retirement accounts (IRAs), and health and welfare plans.

b. *Master trusts* are special trust devices used to bring together various employee benefit trusts of a plan sponsor for ease of administration. For instance, an employer may have similar benefit plans for different subsidiaries, divisions, or classes of employees. Rather than maintain separate employee benefit trusts for each plan, all of the plans, subject to restrictions of ERISA, may pool the trust assets in a single master trust and maintain separate subaccounts for each plan to preserve accountability. A master trust may also be structured to establish separate pools of trust assets managed by different investment advisers selected by the plan sponsor.

Collective Trust Funds

17.09 Collective trusts are arrangements in which the funds of individual trusts (that is, personal or employee benefit trusts) are pooled to achieve greater diversification of investment, stability of income, or other investment objectives. Under federal statute there are two types of collective investment trusts: (*a*) common trust funds,[4] which are maintained exclusively for the collective investment of accounts for which the institution serves as trustee, executor, administrator, conservator, and guardian, and (*b*) commingled pension trust funds, which consist solely of assets of retirement, pension, profit-sharing, stock bonus, or other trusts that are exempt from federal income taxes.

Regulatory Matters

17.10 Some banks and savings institutions are also involved with mutual funds. Their involvement may range from corporate trust activities, which are

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[4] Common trust funds are exempt from federal income taxes under Section 584 of the Internal Revenue Code.

generally administrative in nature, to investment advisory activities, or may simply involve custodial activities. Some institutions sell funds sponsored by an independent fund group. Others may use their name on a fund sponsored by a third party.

17.11 12 CFR Part 9 sets forth rules concerning a national bank's operation of collective investment trusts. The independent accountant may be engaged to perform certain agreed-upon procedures required by the Office of the Comptroller of the Currency (OCC) relative to all other trust activities. Regulatory approval is generally required before institutions enter into operations involving mutual funds.

Accounting and Financial Reporting

17.12 While a trust department or trust company may have responsibility for the custody of trust assets, they are not assets of the institution and, therefore, should not be included in the institution's financial statements. However, cash accounts of individual trusts are often deposited with the institution in demand and time deposit accounts, and revenues and expenses related to fees for trust activities are recognized in the institution's income. Trust department income should be presented on the accrual basis. Banks and savings institutions often make financial statement disclosures describing the nature of the trust activities and are required to apply the provisions of Financial Accounting Standards Board (FASB) Statement on Financial Accounting Standards No. 5, *Accounting for Contingencies*, to any contingencies that may exist related to trust activities.

Auditing

Objectives

17.13 The primary objectives of financial statement audit procedures applied in the trust operations area are to obtain reasonable assurance that—

a. The institution has properly described and disclosed in the financial statements contingent liabilities associated with trust activities.

b. Fee income resulting from trust activities is recognized properly in the institution's financial statements.

Planning

17.14 The independent accountant should consider the following factors in establishing the scope of audit procedures to be performed:

a. The organization of the trust department and the degree of separation from the commercial banking departments (for example, the role of legal counsel in trust account administration and the vulnerability to disclosure of insider information)

b. The nature of comments on trust operations indicated in supervisory agency or internal audit reports

c. The extent and nature of insurance coverage

d. The type and frequency of lawsuits, if any, brought against the institution and arising from trust operations

e. The nature, complexity, and reliability of data-processing systems

f. The nature and extent of lending of securities from trust accounts

The significance of an institution's exposure to liability (including liability related to the reporting of tax information) is a function of (*a*) the relative significance of the trust assets administered, (*b*) whether the institution has discretionary investment authority, (*c*) the complexity of transactions entered into by the trust, (*d*) the number of trusts administered, and (*e*) the effectiveness of administration of the trust. Thus, the importance of the trust department in an audit of an institution's financial statements should not be underestimated.

Internal Control Structure Over Financial Reporting and Possible Tests of Controls[5]

17.15 Accounting systems for trust departments generally use sophisticated electronic data-processing systems. The accounting records of a trust department generally should reflect the department's asset holdings and liabilities to trust customers, the status of each trust account, and all transactions relating to each trust account. Records providing detailed information for each trust account generally should include the following:

- Principal (corpus) control account
- Principal cash account
- Income cash account
- Investment records for each asset owned, such as stocks, bonds, notes and mortgages, savings and time accounts, real property, and sundry assets
- Liability record for each principal trust liability
- Investment income

17.16 The independent accountant should generally evaluate trust departments' and trust companies' overall internal control structure over financial reporting, including the following controls.

- Individual account and departmental transactions (activity control) and suspense items are reconciled and recorded in a complete, accurate, and timely manner.
- Written policies, procedures, and controls exist for securities lending activities, including review of the borrower's creditworthiness, a formal lending agreement, and minimum collateral requirements.
- Periodic reconciliations of the trust funds on deposit with the institution or its custodian are performed by an employee having no check-signing authority or access to unissued checks and related records.
- Measures have been taken to safeguard trust assets by dual control.
- Vault deposits and withdrawals are reconciled with accounting records to promptly reflect the purchase and sale of trust assets.

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[5] In December 1995, the Auditing Standards Board (ASB) issued SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). SAS No. 78 revises the definition and description of internal control contained in the SASs to recognize the definition and description contained in *Internal Control—Integrated Framework* published by the Committee of Sponsoring Organizations of the Treadway Commission. SAS No. 78 is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted.

In conjunction with SAS No. 78, the ASB issued SSAE No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2* (AICPA, *Professional Standards*, vol.1, AT sec. 400). SSAE No. 6 conforms the description of elements of an entity's internal control to the components of internal control contained in SAS No. 78 and the *Internal Control—Integrated Framework*. SSAE No. 6 is effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, with earlier application permitted.

- Reconciliation of agency accounts (for example, dividends, coupons, and bond redemptions) are performed regularly by an employee having no access to unissued checks or participation in the disbursement function.
- Periodic physical inspection of assets or confirmation of trust assets is conducted by an independent person.
- There is frequent reporting and written approval of uninvested cash balances and overdrafts.
- Procedures exist to ensure compliance with income and other tax filing and remittance requirements.
- Reviews are conducted to make sure all duties required by the governing trust instruments or agency contracts (legal compliance) are performed.

Financial Reporting Controls of the Trust

17.17 Additional controls that the independent accountant may wish to consider for engagements not limited to the audit of financial statements (for example, directors' exams and engagements under SAS No. 70) include the following.

- Authorization and review procedures are in place to ensure that assets accepted into a trust conform with provisions of the trust and applicable laws and regulations.
- The physical and administrative security (physical control) of assets for which the trust department has responsibility is segregated from transaction authorization and recordkeeping.
- Trust assets are segregated from the institution's assets and are periodically inspected by people outside the trust department or trust company.
- Trust assets are registered in the name of the institution as fiduciary or in the name of the nominee.
- Proper approval is obtained from cofiduciaries (or investment power holders in self-directed trusts) for investment changes, disbursements, and so forth.
- Approval of the individual purchase and sale of all trust investments is performed by the trust or investment committee or its designees. It is important that for assets where the trustee has discretionary (investment powers) authority, investment restrictions imposed by the client are being adhered to. The independent accountant should also obtain an understanding of computer models that may be used to assist in making investment decisions or to determine whether the investment objectives of the funds are being met.
- Procedures exist to ensure proper classification of trust assets, both by trust title and by nature of asset, daily posting of journals containing detailed descriptions of principal and income transactions, and establishment of control accounts for various asset classifications, including principal and income cash.
- Procedures exist to safeguard unissued supplies of stocks and bonds by dual control.
- Periodic mailings are made of account statements of activity to an external party designated by the client.

- Policies and procedures exist related to identification and resolution of failed trades and the contractual settlement of trades posted to trust accounts.

Substantive Tests

17.18 ***Testing of Trust Department Revenues and Expenses.*** Although a substantial amount of activity may be conducted and reported on within the trust department, items typically reflected in the institution's financial statements are income from trust or agency services and trust operation expenses. Those areas may be tested independently or may be integrated, as appropriate, with other tests of trust operations.

17.19 ***Contingent Liabilities.*** The independent accountant should design audit procedures to determine whether any contingent liabilities should be recognized or disclosed in the institution's financial statements. Acceptance of certain assets, such as real estate with environmental contamination that subjects the trustee to environmental liabilities and ineligible investments in employee benefit trusts subject to ERISA, may result in substantial liabilities for both the trust and trustee. Further, the independent accountant should determine the extent to which an institution has engaged in off-balance-sheet activities that create commitments or contingencies, including innovative transactions involving securities and loans (such as transfers with recourse or put options), that could affect the financial statements, including disclosures in the notes. Inquiries of management relating to such activities should be formalized in the representation letter normally obtained at year-end. The independent accountant should also review the institution's documentation to determine whether particular transactions are sales or financing arrangements.

Substantive Tests Related to the Trust

17.20 Additional substantive tests that the independent accountant may wish to consider for engagements not limited to the audit of financial statements (for example, directors' exams and engagements under SAS No. 70) follow.

17.21 Examination of a trust department's activity includes tests of systems and procedures that are common to the management of all or most individual trusts or agency accounts and tests of the activity in selected representative individual trust accounts in each area of trust department service (for example, personal, corporate, and employee benefit).

17.22 ***Testing of Trust Activities' Common Procedures.*** The procedures followed for the numerous types of trusts and agency activities involve many common or similar functions. Tests of the department's conduct of those activities may be done on the department as a whole rather than on individual trusts. Functions that may be tested by the department include the following:

- Opening of new accounts
- Receipt and processing of the initial assets that constitute an account
- Processing of purchases, sales, and exchanges of principal assets
- Receipt and payment of cash or other assets
- Collateralization of trust assets held in deposit accounts at the institution, affiliate, or outside custodian, where required
- Execution of specified trust or agency activities

- Determination of fees and charging of fees to accounts
- Processing of trust assets in and out of the trust vault
- Closing of accounts

17.23 ***Testing of Account Activity.*** The independent accountant should perform sufficiently detailed tests to obtain reasonable assurance that transactions and activities within the various types of trust accounts are being conducted properly. The tests should cover asset validation, asset valuation, and account administration. For asset validation, a sample of accounts should be selected, trial balances of assets should be obtained, and the physical existence of assets for which the trust is responsible should be determined on a test basis. For account administration, a sample of trust accounts should be selected for testing of individual transactions. If appropriate, certain of those transactions may be incorporated in testing of common procedures in the trust department. The independent accountant may coordinate the selection of accounts for testing asset validation and account administration. The independent accountant should consider performing the following procedures for the selected accounts:

a. Read the governing instrument and note the significant provisions.

b. Review activity during the period being audited for compliance with the governing trust instrument and applicable laws and regulations.

c. Review the assets held for compliance with the provisions of the governing trust instrument.

d. Examine brokers' advices or other documentary evidence supporting the purchase and sale of investments.

e. For real estate accepted or acquired, determine that appropriate measures are taken to identify potential environmental liability and to properly document the evaluation.

f. Ascertain that real estate holdings are insured and are inspected on a periodic basis and that appraisals are performed or otherwise obtained as required by the governing trust instrument and applicable laws and regulations.

g. Obtain reasonable assurance that income from trust assets has been received and credited to the account.

h. Obtain reasonable assurance that required payments have been made.

i. Test computation and collection of fees.

j. Determine whether the account has been reviewed by the investment committee as required by the supervisory authorities or by local regulations.

k. Test the amounts of uninvested cash to determine whether amounts maintained and time held are not unreasonable.

l. Review any overdrafts and obtain reasonable assurance that they have a valid business purpose and are covered by appropriate borrowings to avoid violations of laws and regulations.

m. Independently test market values used in valuing investments.

n. Review the "soft dollar" charges allocated to funds for appropriateness.

o. Determine whether required tax returns have been filed.

p. Review the adequacy of trust reporting of co-trustees and beneficiaries.

q. Confirm individual trust account assets, liabilities, and activity with co-trustees and beneficiaries.

Audits of Unit Investment Trusts

17.24 The AICPA Audit and Accounting Guide *Audits of Investment Companies* provides guidance on the auditing of financial statements of investment companies and unit investment trusts.

Chapter 18

Reports on Audited Financial Statements

Introduction

18.01 The guidance in Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), as amended, applies to audit reports on the financial statements of banks or savings institutions. Such reports may contain an unqualified opinion, an unqualified opinion with explanatory language, a qualified opinion, an adverse opinion, or a disclaimer of opinion. This chapter contains a brief discussion of each of those reports, with an emphasis on illustrating issues that an independent accountant may encounter in the industry. The reports are illustrative; the facts and circumstances of each particular audit will govern the appropriate form of report.

Reports

Unqualified Opinion

18.02 The independent accountant's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles (GAAP). This conclusion may be expressed only when the independent accountant has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards (GAAS). The following is an illustration of an independent accountant's standard report (unqualified opinion) on the financial statements of a bank or savings institution.

<u>Independent Auditor's Report</u>

To the Board of Directors
ABC Institution:

We have audited the accompanying balance sheets of ABC Institution as of December 31, 19X2 and 19X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Institution's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Institution as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

Explanatory Language Added to the Auditor's Standard Report

18.03 Certain circumstances, while not affecting the independent accountant's unqualified opinion, may require that the independent accountant add an explanatory paragraph (or other explanatory language) to the standard report. A number of such circumstances are listed in paragraph 11 of SAS No. 58. This section deals with one of them: the existence of substantial doubt about an institution's ability to continue as a going concern.

18.04 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), as amended, describes the independent accountant's responsibility for evaluating whether there is substantial doubt about the ability of the entity whose financial statements are being audited to continue as a going concern for a reasonable period of time. Chapter 3 describes going concern considerations as they relate to banks and savings institutions and discusses how an institution's regulatory capital position should be considered in the independent accountant's assessment of whether there is substantial doubt about the institution's ability to continue as a going concern. If the independent accountant concludes that there is substantial doubt about an institution's ability to continue as a going concern for a reasonable period of time, the report should include an explanatory paragraph (following the opinion paragraph) to express that conclusion. The independent accountant's conclusion about the entity's ability to continue as a going concern should be expressed through the use of the phrase "substantial doubt about its [the entity's] ability to continue as a "going concern" or similar wording that includes the terms "substantial doubt" and "going concern."[1] The following is an illustration of an independent accountant's report on the financial statements of a bank or savings institution that includes an explanatory paragraph because of the existence of substantial doubt about the institution's ability to continue as a going concern for a reasonable period of time.

<u>Independent Auditor's Report</u>

To the Board of Directors
ABC Institution:

We have audited the accompanying balance sheets of ABC Institution as of December 31, 19X2 and 19X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Institution's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits to ob-

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[1] Footnote 5 to SAS No. 77, *Amendments to Statements on Auditing Standards No. 22,* Planning and Supervision, *No. 59,* The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, *and No. 62,* Special Reports, says, in part:

In a going-concern explanatory paragraph, the auditor should not use conditional language in expressing a conclusion concerning the existence of substantial doubt about the entity's ability to continue as a going concern.

tain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Institution as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The accompanying financial statements have been prepared assuming that ABC Institution will continue as a going concern. As discussed in Note XX to the financial statements, at December 31, 19X2, the Institution did not meet its minimum capital requirements established by the Office of the Comptroller of the Currency (OCC). The Institution also has suffered recurring losses from operations. The Institution has filed a capital plan with the OCC outlining its plans for attaining the required levels of regulatory capital by December 31, 19X4. To date, the Institution has not received notification from the OCC regarding acceptance or rejection of its capital plan. Failure to meet the capital requirements and interim capital targets included in the capital plan would expose the Institution to regulatory sanctions that may include restrictions on operations and growth, mandatory asset dispositions, and seizure. These matters raise substantial doubt about the ability of ABC Institution to continue as a going concern. The ability of the Institution to continue as a going concern is dependent on many factors, one of which is regulatory action, including ultimate acceptance of its capital plan. Management's plans in regard to these matters are described in Note XX. The accompanying financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[*Signature*]

[*Date*]

18.05 SAS No. 59 states that the inclusion of an explanatory paragraph (following the opinion paragraph) in the independent accountant's report as described above serves adequately to inform users of the financial statements of the independent accountant's substantial doubt. Nevertheless, SAS No. 59 does not preclude the independent accountant from declining to express an opinion in cases involving uncertainties. If the independent accountant disclaims an opinion, the uncertainties and their possible effects should be disclosed in an appropriate manner and the independent accountant's report should state all of the substantive reasons for the disclaimer of opinion. The following is an illustration of an independent accountant's disclaimer of opinion because of the existence of substantial doubt about an institution's ability to continue as a going concern for a reasonable period of time.

Independent Auditor's Report

To the Board of Directors
ABC Institution:

We have audited the accompanying balance sheets of ABC Institution as of December 31, 19X2 and 19X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Institution's management. Our responsibility is to report on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our report.[2]

The accompanying financial statements have been prepared assuming that ABC Institution will continue as a going concern. As discussed in Note XX to the financial statements, at December 31, 19X2, the Institution did not meet its minimum capital requirements established by the Office of the Comptroller of the Currency (OCC). The Institution also has suffered recurring losses from operations. The Institution has filed a capital restoration plan with the OCC outlining its plans for attaining the required levels of regulatory capital by December 31, 19X4. To date, the Institution has not received notification from the OCC regarding acceptance or rejection of its capital restoration plan. Failure to meet the capital requirements and interim capital targets included in the Institution's capital plan would expose the Bank to regulatory sanctions that may include restrictions on operations and growth, mandatory asset dispositions, and seizure. These matters raise substantial doubt about the ability of ABC Institution to continue as a going concern. The ability of the Institution to continue as a going concern is dependent on many factors, one of which is regulatory action, including ultimate acceptance of its capital plan. Management's plans in regard to these matters are described in Note XX. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Because of the significance of the uncertainty discussed above, we are unable to express, and we do not express, an opinion on the financial statements for the year ended December 31, 19X2.

In our opinion, the 19X1 financial statements referred to above present fairly, in all material respects, the financial position of XYZ Bank as of December 31, 19X1, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

Emphasis of a Matter

18.06 In some circumstances, the independent accountant may wish to emphasize a matter regarding the financial statements but, nevertheless, intends to express an unqualified opinion. For example, the independent accountant may wish to emphasize that the bank or savings institution is a subsidiary of a holding company or that it has had significant transactions with related parties, or the independent accountant may wish to emphasize an unusually important subsequent event or an accounting matter affecting the comparability of the financial statements with those of the preceding period. Such explanatory information should be presented in a separate paragraph of

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[2] If the independent accountant was disclaiming an opinion due to a scope limitation, this paragraph would be omitted.

the independent accountant's report that may precede or follow the opinion paragraph. Phrases such as "with the foregoing explanation" should not be used in the opinion paragraph in situations of this type. The following is an illustration of an unqualified opinion with an emphasis of a matter paragraph regarding an institution's failure to meet minimum regulatory capital standards on the institution's financial statements.

Independent Auditor's Report

To the Board of Directors
ABC Institution:

We have audited the accompanying balance sheets of ABC Institution as of December 31, 19X2 and 19X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Institution's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note XX to the financial statements, at December 31, 19X2, the Institution failed to meet the risk-based capital requirement established by the Federal Deposit Insurance Corporation (FDIC). The Institution has filed, and the FDIC has accepted, a capital plan for attaining the required level of regulatory risk-based capital by December 31, 19X3.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Institution as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

Qualified Opinion

18.07 Paragraphs 20 through 57 of SAS No. 58 describe certain circumstances that may require the independent accountant to qualify his or her opinion on financial statements. A qualified opinion states that, except for the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows in conformity with GAAP. Such an opinion is expressed when—

a. There is a lack of sufficient competent evidential matter or there are restrictions on the scope of the audit that have led the independent accountant to conclude that an unqualified opinion cannot be expressed and the independent accountant has concluded not to disclaim an opinion.

b. The independent accountant believes, on the basis of the audit, that the financial statements contain a departure from GAAP, the effect of which is material, and has concluded not to express an adverse opinion.

Adverse Opinion

18.08 Paragraphs 58 through 60 of SAS No. 58 describe adverse opinions. An adverse opinion states that the financial statements do not present fairly the financial position or the results of operations or cash flows in conformity with GAAP. Such an opinion is expressed when, in the independent accountant's judgment, the financial statements taken as a whole are not presented fairly in conformity with GAAP. When the independent accountant expresses an adverse opinion, he or she should disclose in a separate explanatory paragraph(s) preceding the opinion paragraph of the report (*a*) all the substantive reasons for the adverse opinion and (*b*) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable. If the effects are not reasonably determinable, the report should so state. When an adverse opinion is expressed, the opinion paragraph should include a direct reference to a separate paragraph that discloses the basis for the adverse opinion.

Disclaimer of Opinion

18.09 Paragraphs 61 to 63 of SAS No. 58 describe disclaimers of opinion. Paragraph 61 of SAS No. 58 says:

> A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. An auditor may decline to express an opinion whenever he is unable to form or has not formed an opinion as to fairness of presentation of the financial statements in conformity with generally accepted accounting principles. If the auditor disclaims an opinion, the auditor's report should give all of the substantive reasons for the disclaimer.

18.10 Paragraph 62 of SAS No. 58 says:

> A disclaimer is appropriate when the auditor has not performed an audit sufficient in scope to enable him to form an opinion on the financial statement. A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his audit, that there are material departures from generally accepted accounting principles (see paragraphs 35 through 57). When disclaiming an opinion because of a scope limitation, the auditor should state in a separate paragraph or paragraphs all of the substantive reasons for the disclaimer. He should state that the scope of his audit was not sufficient to warrant the expression of an opinion. The audit should not identify the procedures that were performed nor include the paragraph describing the characteristics of an audit (that is, the scope paragraph of the auditor's standard report); to do so may tend to overshadow the disclaimer. In addition, he should also disclose any other reservations he has regarding fair presentation in conformity with generally accepted accounting principles. [Footnote Omitted.]

Chapter 19

Illustrative Consolidated Financial Statements

Introduction

19.01 This chapter contains illustrative consolidated financial statements prepared in conformity with generally accepted accounting principles (GAAP). The financial statements are for illustrative purposes only; are not intended to be comprehensive and are not intended to establish preference among alternative principles acceptable under GAAP. Decisions about the application of the GAAP discussed in the accounting and financial reporting sections of this Guide should not be made by reference to the illustrative financial statements but by a careful reading of the specified authoritative literature. The illustrative financial statements reflect many of the minimum disclosure requirements for a bank or stock savings institution but do not include all of the amounts or transactions discussed in other chapters of the Guide or that might be found in practice.[1] For example, the illustrative notes indicate the subject matter generally required to be disclosed, but they should be expanded, reduced, or otherwise modified to suit individual circumstances based on a careful reading of the specified authoritative literature.

19.02 The illustrative financial statements do not include other transactions not unique to banks or savings institutions, such as disclosures about segments, employee benefit plans, certain risks and uncertainties, or postemployment benefits other than pensions. Preparers and auditors should consult authoritative pronouncements for guidance on presenting such other information.

19.03 The illustrative financial statements do not reflect rules and releases of the Securities and Exchange Commission (SEC) that, for SEC registrants, have an authority similar to other officially established accounting principles. See footnote 1 to the Preface to the Guide.

19.04 As discussed below, preparers and auditors of financial statements of banks and savings institutions also should be familiar with the rules and regulations of the federal banking regulatory agencies that relate to the form and content of financial statements that are required to be prepared in conformity with GAAP and filed with the agencies.

19.05 The illustrative financial statements are in conformity with accounting standards issued up to and including Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 122, *Accounting for Mortgage Servicing Rights.* Preparers and auditors of financial statements should refer to subsequent FASB Statements and other GAAP for additional requirements.

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[1] Financial statements for mutual savings associations would not substantially differ from those presented here. The principal differences are inclusion herein of—

- A stockholders' equity section in the statement of financial condition of a stock institution.
- A statement of changes in stockholders' equity, which replaces the statement of changes in retained earnings presented by a mutual association.
- Earnings-per-share data on the face of the income statement of a stock institution.

19.06 Banks and savings institutions generally present unclassified balance sheets.

Supplemental Requirements

19.07 Preparers of financial statements should be familiar with those rules and regulations of the federal banking regulatory agencies that relate to the form and content of general-purpose financial statements, rather than regulatory financial reports, filed with regulators. Such requirements involve additional information prepared in conformity with GAAP (rather than regulatory accounting practices) but that is not necessary for financial statements to be in conformity with GAAP. (Paragraphs 2.82 through 2.86 discuss the difference between regulatory financial reporting and financial statements prepared in conformity with GAAP.)

Illustrative Consolidated Financial Statements

19.08

XYZ Bank and Subsidiary
Consolidated Statements of Financial Condition
December 31, 19X2 and 19X1

Assets	*19X2*	*19X1*
Cash and due from banks	$ 3,815,158	$ 2,496,836
Interest-bearing deposits with banks	4,558,992	4,443,446
Federal funds sold and securities purchased under agreements to resell	1,066,170	152,930
Trading securities	30,374	30,118
Securities available for sale	6,148,700	5,045,456
Securities held to maturity	2,049,566	1,681,818
Loans held for sale, net of unrealized losses of $1,850 in 19X2 and $1,032 in 19X1	931,962	860,454
Loans receivable, net of allowance for loan losses of $597,769 in 19X2 and $582,438 in 19X1	27,076,985	26,731,035
Accrued interest receivable	312,873	305,226
Premises and equipment	750,859	693,141
Customers' liability on acceptances	85,569	55,725
Mortgage servicing rights	1,035,862	980,325
Excess servicing receivables	1,143,692	994,225
Foreclosed real estate, net of allowances of $124,352 in 19X2 and $90,989 in 19X1	216,838	186,536
Other assets	438,892	228,976
Total assets	$ 49,662,492	$ 44,886,247
Liabilities and Shareholders' Equity		
Liabilities:		
Demand deposits	$ 9,073,765	$ 8,068,695
Savings and NOW deposits	8,266,877	8,416,705
Other time deposits	24,173,312	21,908,521
Total deposits	41,513,954	38,393,921
Federal funds purchased and securities sold under agreements to repurchase	2,846,105	1,946,451
Other borrowed funds	648,207	490,183
Acceptances outstanding	85,569	55,725
Accrued expenses and other liabilities	1,129,842	920,086
Long-term debt	330,740	343,461
Total liabilities	46,554,417	42,149,827
Shareholders' equity:		
Common Stock — $1 par value; 1,000,000 shares authorized; 734,480 and 727,200 shares issued and outstanding in 19X2 and 19X1, respectively.	734,480	727,200
Additional paid-in capital	316,204	280,649
Retained earnings	2,054,799	1,725,823
Net unrealized appreciation on available-for-sale securities, net of tax of $1,728 in 19X2 and $1,832 in 19X1	2,592	2,748
Total shareholders' equity	3,108,075	2,736,420
Total liabilities and shareholders' equity	$ 49,662,492	$ 44,886,247

The accompanying notes are an integral part of these consolidated financial statements.

19.09

XYZ Bank and Subsidiary
Consolidated Statements of Income
Years Ended December 31, 19X2 and 19X1

	19X2	*19X1*
Interest Income:		
Loans receivable	$ 3,303,613	$ 2,784,548
Securities available for sale	504,587	394,159
Securities held to maturity	168,195	131,386
Trading securities	4,641	15,819
Federal funds sold and securities purchased under agreements to resell	231,007	135,027
Deposits with banks	367,380	336,644
Total interest income	4,579,423	3,797,583
Interest Expense:		
Deposits	2,500,222	1,912,015
Federal funds purchased and securities sold under agreements to repurchase	351,175	324,356
Other borrowed funds	39,434	30,567
Long-term debt	32,873	30,012
Total interest expense	2,923,704	2,296,950
Net interest income	1,655,719	1,500,633
Provision for loan losses	(174,871)	(139,345)
Net interest income after provision for loan losses	1,480,848	1,361,288
Noninterest Income:		
Income from fiduciary activities	241,799	212,843
Service charges on deposit accounts	162,270	152,901
Loan servicing fees	35,625	29,366
Other service charges and fees	145,371	118,958
Net trading account profit and losses	2,181	3,107
Net realized gains on sales of available-for-sale securities	2,938	806
Net gains from sale of loans	50,153	55,638
Other income	82,734	88,319
Total other income	723,071	661,938
Noninterest Expenses:		
Salaries and employee benefits	877,535	806,995
Occupancy expense	244,510	234,721
Loss on foreclosed real estate	10,368	18,334
Deposit insurance premium	95,482	90,225
Other expense	332,446	299,220
Total other expenses	1,560,341	1,449,495
Income before income taxes	643,578	573,731
Income tax expense	125,538	109,367
Net income	$ 518,040	$ 464,364
Net income per share of common stock	$ 0.71	$ 0.64
Average shares outstanding	730,840	723,601

The accompanying notes are an integral part of these consolidated financial statements.

19.10

XYZ Bank and Subsidiary
Consolidated Statements of Shareholders' Equity
Years Ended December 31, 19X2 and 19X1

	Common Stock	*Additional Paid-in Capital*	*Retained Earnings*	*Net Unrealized Appreciation on Available-for-Sale Securities*	*Total Shareholders' Equity*
Balance at December 31, 19X0	$720,002	$255,698	$1,415,741	$2,656	$2,394,097
Net income for 19X1			464,364		464,364
Cash dividends paid — $0.170 per share			(122,133)		(122,133)
1% Stock dividend — 7,198 shares of common stock	7,198	24,951	(32,149)		0
Net changes in unrealized appreciation on available-for-sale securities, net of taxes of $61				92	92
Balance at December 31, 19X1	727,200	280,649	1,725,823	2,748	2,736,420
Net income for 19X2			518,040		518,040
Cash dividend paid — $0.201 per share			(146,229)		(146,229)
1% Stock dividend — 7,280 shares of common stock	7,280	35,555	(42,835)		0
Net changes in unrealized appreciation on available-for-sale securities, net of taxes of $104				(156)	(156)
Balance at December 31, 19X2	$734,480	$316,204	$2,054,799	$2,592	$3,108,075

The accompanying notes are an integral part of these consolidated financial statements.

19.11

XYZ Bank and Subsidiary
Consolidated Statements of Cash Flows
Years Ended December 31, 19X2 and 19X1

	19X2	*19X1*
Cash flows from operating activities:		
Net income	$ 518,040	$ 464,364
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	52,172	74,075
Provision for loan losses	174,871	139,345
Provisions for losses on foreclosed real estate	76,000	20,000
Other gains and losses, net	(38,967)	(36,272)
Deferred income taxes	4,470	15,211
Proceeds from sales of loans held for sale	3,123,146	2,932,567
Originations and purchases of loans held for sale	(3,145,319)	(3,002,731)
Net realized gains on available-for-sale securities	(2,938)	(806)
Net (increase) decrease in trading account securities	(256)	(23,321)
Increase in excess servicing receivables	(363,908)	(657,567)
(Increase) decrease in accrued interest receivable	(7,647)	110,898
Increase in accrued expense and other liabilities	209,756	137,927
(Increase) decrease in other assets	(214,282)	1,395,144
Total adjustments	(132,902)	1,104,470
Net cash provided by operating activities	385,138	1,568,834
Cash flows from investing activities:		
Net (increase) decrease in interest-bearing deposits with banks	(115,546)	14,386
Net (increase) decrease in federal funds sold and securities purchased under agreements to resell	(913,240)	1,039,487
Purchases of available-for-sale securities	(3,136,617)	(2,616,353)
Proceeds from sales of available-for-sale securities	261,752	308,528
Proceeds from maturities of available-for-sale securities	1,774,299	793,375
Purchases of held-to-maturity securities	(1,132,462)	(1,288,652)
Proceeds from maturities of held-to-maturity securities	764,714	396,688
Net increase in loans	(237,719)	(773,714)
Net purchases of premises and equipment	(145,351)	(144,010)
Net expenditures on foreclosed real estate	(76,000)	(128,000)
Proceeds from sale of foreclosed real estate	123,500	90,850
Purchases of mortgage servicing rights	(252,907)	(738,879)
Net cash used in investing activities	(3,085,577)	(3,046,294)
Cash flows from financing activities:		
Net increase in non-interest bearing demand, savings, and NOW deposit accounts	855,242	92,482
Net increase in time deposits	2,264,791	3,326,016
Net increase (decrease) in federal funds purchased and securities sold under agreements to repurchase	899,654	(1,002,435)
Net increase (decrease) in other borrowed funds	158,024	(1,683,788)
Repayment of long-term debt	(12,721)	(16,465)
Dividends paid	(146,229)	(122,133)
Net cash provided by financing activities	4,018,761	593,677
Net increase (decrease) in cash and due from banks	1,318,322	(883,783)
Cash and due from banks at January 1	2,496,836	3,380,619
Cash and due from banks at December 31	$ 3,815,158	$ 2,496,836
Interest paid	$ 2,801,929	$ 2,159,024
Income taxes paid	$ 111,909	$ 32,506

The accompanying notes are an integral part of these consolidated financial statements.

19.12

XYZ Bank and Subsidiary
Notes to Consolidated Financial Statements
December 31, 19X2 and 19X1

(1) Summary of Significant Accounting Policies

(a) Principles of Consolidation

The consolidated financial statements include the accounts of XYZ Bank (the Bank) and its wholly owned subsidiary, which owns all of the Bank's premises. All significant intercompany transactions and balances have been eliminated in consolidation.

(b) Cash Equivalents

For the purpose of presentation in the consolidated statements of cash flows, cash and cash equivalents are defined as those amounts included in the balance-sheet caption "cash and due from banks."

(c) Trading Securities

Government bonds held principally for resale in the near term, and mortgage-backed securities held for sale in conjunction with the Bank's mortgage banking activities, are classified as trading account securities and recorded at their fair values. Unrealized gains and losses on trading account securities are included immediately in other income.

(d) Securities Held to Maturity

Bonds, notes, and debentures for which the Bank has the positive intent and ability to hold to maturity are reported at cost, adjusted for premiums and discounts that are recognized in interest income using the interest method over the period to maturity.

(e) Securities Available for Sale

Available-for-sale securities consist of bonds, notes, debentures, and certain equity securities not classified as trading securities nor as held-to-maturity securities.

Unrealized holding gains and losses, net of tax, on available-for-sale securities are reported as a net amount in a separate component of shareholders' equity until realized.

Gains and losses on the sale of available-for-sale securities are determined using the specific-identification method.

Declines in the fair value of individual held-to-maturity and available-for-sale securities below their cost that are other than temporary have resulted in write-downs of the individual securities to their fair value. The related write-downs have been included in earnings as realized losses.

Premiums and discounts are recognized in interest income using the interest method over the period to maturity.

(f) *Loans Held for Sale*

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated market value in the aggregate. Net unrealized losses are recognized through a valuation allowance by charges to income.

(g) *Loans Receivable*

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding principal adjusted for any charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans and unamortized premiums or discounts on purchased loans.

Discounts and premiums on purchased residential real estate loans are amortized to income using the interest method over the remaining period to contractual maturity, adjusted for anticipated prepayments. Discounts and premiums on purchased consumer loans are recognized over the expected lives of the loans using methods that approximate the interest method.

Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment of the yield of the related loan.

The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received.

The allowance for loan losses is increased by charges to income and decreased by charge-offs (net of recoveries). Management's periodic evaluation of the adequacy of the allowance is based on the Bank's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, and current economic conditions.

(h) *Foreclosed Real Estate*

Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at fair value at the date of foreclosure establishing a new cost basis. After foreclosure, valuations are periodically performed by management and the real estate is carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in loss on foreclosed real estate. The historical average holding period for such properties is eighteen months.

(i) *Income Taxes*

Deferred tax assets and liabilities are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

(j) Premises and Equipment

Land is carried at cost. Bank premises, furniture and equipment, and leasehold improvements are carried at cost, less accumulated depreciation and amortization computed principally by the straight-line method.

(k) Loan Servicing

The cost of mortgage servicing rights is amortized in proportion to, and over the period of, estimated net servicing revenues. Impairment of mortgage servicing rights is assessed based on the fair value of those rights. Fair values are estimated using discounted cash flows based on a current market interest rate. For purposes of measuring impairment, the rights are stratified based on the following predominant risk characteristics of the underlying loans: **[Note: Specify risk characteristics used to stratify for purposes of measuring impairment.]** The amount of impairment recognized is the amount by which the capitalized mortgage servicing rights for a stratum exceed their fair value.

When participating interests in loans sold have an average contractual interest rate, adjusted for normal servicing fees, that differs from the agreed yield to the purchaser, gains or losses are recognized equal to the present value of such differential over the estimated remaining life of such loans. The resulting "excess servicing receivable" or "deferred servicing revenue" is amortized over the estimated life using a method approximating the interest method.

Quoted market prices are not available for the excess servicing receivables. Thus, the excess servicing receivables and the amortization thereon are periodically evaluated in relation to estimated future servicing revenues, taking into consideration changes in interest rates, current prepayment rates, and expected future cash flows. The Bank evaluates the carrying value of the excess servicing receivables by estimating the future servicing income of the excess servicing receivables based on management's best estimate of remaining loan lives and discounted at the original discount rate.

(l) Financial Instruments

All derivative financial instruments held or issued by the Bank are held or issued for purposes other than trading.

Interest-rate exchange agreements. Interest-rate exchange agreements (swaps) used in asset/liability management activities are accounted for using the accrual method. Net interest income (expense) resulting from the differential between exchanging floating and fixed-rate interest payments is recorded on a current basis. Gains or losses on the sales of swaps used in asset/liability management activities are deferred and amortized into interest income or expense over the maturity period of the swap.

Financial futures. Interest-rate futures contracts are entered into by the Bank as hedges against exposure to interest-rate risk and are not for speculation purposes. Changes in the market value of interest-rate futures contracts are deferred while the contracts are open and subsequently amortized into interest income or expense over the maturity period of the hedged assets or liabilities after the contract closes.

Other off-balance-sheet instruments. In the ordinary course of business the Bank has entered into off-balance-sheet financial instruments consisting of commitments to extend credit, commitments under credit-card arrangements, commercial letters of credit, and standby letters of credit. Such financial instruments are recorded in the financial statements when they are funded or related fees are incurred or received.

(m) Fair Values of Financial Instruments

The following methods and assumptions were used by the Bank in estimating fair values of financial instruments as disclosed herein:

Cash and short-term instruments. The carrying amounts of cash and short-term instruments approximate their fair value.

Trading securities. Fair values for trading account securities, which also are the amounts recognized in the consolidated balance sheet, are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments, except in the case of certain swaps, where pricing models are used.

Available-for-sale and held-to-maturity securities. Fair values for securities, excluding restricted equity securities, are based on quoted market prices. The carrying values of restricted equity securities approximate fair values.

Loans receivable. For variable-rate loans that reprice frequently and have no significant change in credit risk, fair values are based on carrying values. Fair values for certain mortgage loans (for example, one-to-four family residential), credit-card loans, and other consumer loans are based on quoted market prices of similar loans sold in conjunction with securitization transactions, adjusted for differences in loan characteristics. Fair values for commercial real estate and commercial loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for impaired loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

Excess servicing receivables. Fair values are estimated using discounted cash flows based on a current market interest rate.

Customers' liabilities on acceptances and acceptances outstanding. The carrying amounts of liabilities on acceptances and acceptances outstanding approximate their fair value.

Deposit liabilities. The fair values disclosed for demand deposits are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). The carrying amounts of variable-rate, fixed-term money-market accounts and certificates of deposit (CDs) approximate their fair values at the reporting date. Fair values for fixed-rate CDs are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Short-term borrowings. The carrying amounts of federal funds purchased, borrowings under repurchase agreements, and other short-term borrowings maturing within 90 days approximate their fair values. Fair values of other short-term borrowings are estimated using discounted cash flow analyses based on the Bank's current incremental borrowing rates for similar types of borrowing arrangements.

Long-term debt. The fair values of the Bank's long-term debt are estimated using discounted cash flow analyses based on the Bank's current incremental borrowing rates for similar types of borrowing arrangements.

Accrued interest. The carrying amounts of accrued interest approximate their fair values.

Off-balance-sheet instruments. Fair values for off-balance-sheet lending commitments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standings.

(n) Net Income Per Share

Net income per share of common stock has been computed on the basis of the weighted-average number of shares of common stock outstanding.

(o) Trust Fees

Trust fees are recorded on the accrual basis.

(2) Debt and Equity Securities

Debt and equity securities have been classified in the consolidated statements of financial condition according to management's intent. The carrying amount of securities and their approximate fair values at December 31 follow.

	Amortized Cost	*Gross Unrealized Gains*	*Gross Unrealized Losses*	*Fair Value*
Available-for-sale securities:				
December 31, 19X2:				
Equity securities	$ 289,199	$ 16	$ 0	$ 289,215
U.S. government and agency securities	4,545,082	4,797	1,268	4,548,611
State and municipal securities	1,237,799	854	83	1,238,570
Other securities	72,300	4	0	72,304
	$6,144,380	$ 5,671	$ 1,351	$6,148,700
December 31, 19X1:				
Equity securities	$ 291,151	$ 0	$ 29	$ 291,122
U.S. government and agency securities	3,303,536	4,718	709	3,307,545
State and municipal securities	1,373,402	1,095	488	1,374,009
Other securities	72,787	0	7	72,780
	$5,040,876	$ 5,813	$ 1,233	$5,045,456

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Held-to-maturity securities:				
December 31, 19X2:				
U.S. government and agency securities	$1,036,191	$ 30,774	$ 8,133	$1,058,832
State and municipal securities	1,013,375	19,681	1,916	1,031,140
	$2,049,566	$ 50,455	$ 10,049	$2,089,972
December 31, 19X1:				
U.S. government and agency securities	$ 775,844	$ 2,771	$ 18,442	$ 760,173
State and municipal securities	905,974	6,649	14,937	897,686
	$1,681,818	$ 9,420	$ 33,379	$1,657,859

Gross realized gains and gross realized losses on sales of available-for-sale securities were $7,461 and $4,523, respectively, in 19X2 and $3,491 and $2,685, respectively, in 19X1.

Unrealized holding gains on trading securities of $1,132 of $1,621 were included in earnings during 19X2 and 19X1, respectively.

The scheduled maturities of securities held-to-maturity and securities (other than equity securities) available-for-sale at December 31, 19X2, were as follows:

	Held-to-maturity securities:		*Available-for-sale securities:*	
	Amortized Cost	*Fair Value*	*Amortized Cost*	*Fair Value*
Due in one year or less	$ 615,914	$ 653,426	$ 1,623,080	$ 1,624,409
Due from one to five years	579,535	609,612	1,710,771	1,711,974
Due from five to ten years	502,694	493,840	1,483,939	1,484,982
Due after ten years	351,423	333,094	1,037,391	1,038,120
	$ 2,049,566	$ 2,089,972	$ 5,855,181	$ 5,859,485

For purposes of the maturity table, mortgage-backed securities, which are not due at a single maturity date, have been allocated over maturity groupings based on the weighted-average contractual maturities of underlying collateral. The mortgage-backed securities may mature earlier than their weighted-average contractual maturities because of principal prepayments.

Assets, principally securities, carried at approximately $5,466,000 at December 31, 19X2, and $2,895,000 at December 31, 19X1, were pledged to secure public deposits and for other purposes required or permitted by law.

(3) Securities Purchased Under Agreements to Resell

The Bank enters into purchases of mortgage-backed securities under agreements to resell substantially identical securities. Securities purchased under agreements to resell at December 31, 19X2, consist of mortgage-backed securities.

The amounts advanced under these agreements represent short-term loans and are reflected as a receivable in the statement of financial condition. The securities underlying the agreements are book-entry securities. During the period, the securities were delivered by appropriate entry into the Bank's account maintained at the Federal Reserve Bank of New York (or MBS Clearing Corporation for GNMA securities) or into a third-party custodian's account designated by the Bank under a written custodial agreement that explicitly recognizes the Bank's interest in the securities. At December 31, 19X2, these agreements matured within 90 days and no material amount of agreements to resell securities purchased was outstanding with any individual dealer. Securities purchased under agreements to resell averaged approximately $902,000 during 19X2, and the maximum amounts outstanding at any month-end during 19X2 was $963,733.

(4) Loans Receivable

The components of loans in the consolidated statements of financial condition were as follows:

	19X2	*19X1*
Commercial	$ 16,274,861	$ 16,454,963
Real estate construction	912,431	1,007,038
Commercial real estate	2,504,495	2,279,850
Residential real estate	3,659,734	3,516,982
Consumer	4,627,759	4,351,372
Subtotal	27,979,280	27,610,205
Net deferred loan fees, premiums and discounts	(304,526)	(296,732)
Allowance for loan losses	(597,769)	(582,438)
	$ 27,076,985	$ 26,731,035

An analysis of the change in the allowance for loan losses follows:

	19X2	*19X1*
Balance at January 1	$ 582,438	$ 542,232
Loans charged off	(190,618)	(126,324)
Recoveries	31,078	27,185
Net loans charged off	(159,540)	(99,139)
Provision for loan losses	174,871	139,345
Balance at December 31	$ 597,769	$ 582,438

Impairment of loans having recorded investments of $1,238,657 at December 31, 19X2 and $1,089,563 at December 31, 19X1 has been recognized in conformity with FASB Statement No. 114, as amended by FASB Statement No. 118. Recorded investments in other impaired loans were $111,325 at December 31, 19X2 and $109,522 at December 31, 19X1. The average recorded investment in impaired loans during 19X2 and 19X1 was $1,312,760 and $1,132,176, respectively. The total allowance for loan losses related to these loans was $321,549 and $303,752 on December 31 of 19X2 and 19X1, respectively. Interest income on impaired loans of $1,162 and $1,032 was recognized for cash payments received in 19X2 and 19X1, respectively.

Loans having carrying values of $164,170 and $133,872 were transferred to foreclosed real estate in 19X2 and 19X1, respectively.

The Bank is not committed to lend additional funds to debtors whose loans have been modified.

(5) Premises and Equipment

Components of properties and equipment included in the consolidated statements of financial condition at December 31, 19X2 and 19X1 were as follows:

	19X2	*19X1*
Cost:		
Land	$ 78,188	$ 72,895
Bank premises	520,817	503,179
Furniture and equipment	666,684	560,724
Leasehold improvements	125,046	115,301
Total cost	1,390,735	1,252,099
Less accumulated depreciation	(639,876)	(558,958)
Net book value	$ 750,859	$ 693,141

The Bank's main office building, which has a net book value of $186,981, is pledged to collateralize the 9.25 percent mortgage payable.

Certain Bank facilities and equipment are leased under various operating leases. Rental expense was $55,811 in 19X2 and $56,610 in 19X1.

Future minimum rental commitments under noncancelable leases are:

19X3	$ 28,931
19X4	27,016
19X5	15,968
19X6	14,029
19X7	11,603
Thereafter	78,154
	$ 175,701

(6) Loan Servicing

Mortgage loans serviced for others are not included in the accompanying consolidated statements of financial condition. The unpaid principal balances of mortgage loans serviced for others was $213,481,135 and $189,654,158 at December 31, 19X2 and 19X1, respectively.

Custodial escrow balances maintained in connection with the foregoing loan servicing, and included in demand deposits, were approximately $1,532,125 and $1,035,125 at December 31, 19X2 and 19X1, respectively.

Mortgage servicing rights of $616,815 and $1,396,446 were capitalized in 19X2 and 19X1, respectively. Mortgage servicing rights have been written down to their fair value of $1,035,862 and $980,325 at December 31, 19X2 and 19X1, respectively. Amortization of mortgage servicing rights was $394,451 and $102,578 in 19X2 and 19X1, respectively.

Following is an analysis of the aggregate changes in the valuation allowances for mortgage servicing rights in 19X2 and 19X1:

Balance, January 1, 19X1	$ 1,826
Additions	5,632
Reductions	(903)
Direct write-downs	(240)
Balance, December 31, 19X1	6,315
Additions	3,492
Reductions	(1,212)
Direct write-downs	(360)
Balance at December 31, 19X2	$ 8,235

(7) Foreclosed Real Estate

Activity in the allowance for losses on foreclosed real estate is as follows:

Balance at January 1, 19X1	$ 87,521
Provision charged to income	20,000
Charge-offs, net of recoveries	(16,532)
Balance at December 31, 19X1	90,989
Provision charged to income	76,000
Charge-offs, net of recoveries	(42,637)
Balance at December 31, 19X2	$ 124,352

Loss on foreclosed real estate includes net expense of $6,900 in 19X2 and net revenue of $15,029 in 19X1 from operation of foreclosed real estate.

(8) Deposits

The aggregate amount of short-term jumbo CDs, each with a minimum denomination of $100,000, was approximately $2,315,158 and $1,931,582 in 19X2 and 19X1, respectively.

At December 31, 19X2, the scheduled maturities of CDs are as follows:

19X3	$ 19,338,650
19X4	3,625,861
19X5	612,351
19X6	376,294
19X7 and thereafter	220,156
	$ 24,173,312

(9) Long-Term Debt

Long-term debt consisted of the following at year-end:

	19X2	*19X1*
Floating-rate notes due 19Y6	$ 290,000	$ 290,000
9.25% mortgage	15,444	19,746
9.00% subordinated term loan due 20X4	15,000	15,000
Total Bank	320,444	324,746
Notes of subsidiary	10,296	18,715
	$ 330,740	$ 343,461

In 19W9, the Bank issued $290,000 of floating-rate notes due in 19Y6 in a private placement with an insurance company. Interest is calculated semiannually at the rate of .75 percent over the six-month Eurodollar deposit rate (9.75 percent at December 31, 19X2). In September 19X4, the notes may be redeemed without premium, in whole or in part, at the option of the Bank. A portion of the notes qualifies as capital for bank regulatory purposes, which may limit the Bank's ability to repay the notes prior to maturity. At December 31, 19X2, $174,000 qualified as capital.

The 9.25 percent mortgage is payable in equal annual installments of $6,128 on December 15 each year through 19X5. The Bank may prepay between $2,400 and $6,128 annually without penalty and, in addition, may redeem the remaining notes at declining premiums (2.92 percent at December 31, 19X2).

The 9 percent subordinate term loan due May 31, 20X4, is from a nonaffiliated bank and may not be repaid prior to June 30, 19X6.

The notes of the Bank's subsidiary represent amounts due to prior owners of certain of the Bank's premises. Such notes mature at various dates through 19X5. These notes are unsecured and have interest rates from 9.5 percent to 11 percent.

Except for the floating rate notes due in 19X6, there are no significant amounts of long-term debt due in any one year.

(10) Other Borrowed Funds

Federal funds purchased and securities sold under agreements to repurchase generally mature within one to four days from the transaction date. Other borrowed funds consist of term federal funds purchased and treasury tax and loan deposits and generally are repaid within one to 120 days from the transaction date.

Mortgage-backed securities sold under dollar reverse repurchase agreements were delivered to the broker-dealers who arranged the transactions. The broker-dealers may have sold, loaned, or otherwise disposed of such securities to other parties in the normal course of their operations, and have agreed to resell to the Bank substantially identical securities at the maturities of the agreements. The agreements at December 31, 19X2, mature within three months.

Information concerning securities sold under agreements to repurchase is summarized as follows:

	19X2	*19X1*
Average balance during the year	$ 2,135,165	$ 1,231,685
Average interest rate during the year	8.13%	8.35%
Maximum month-end balance during the year	$ 2,356,215	$ 1,465,152
Mortgage-backed securities underlying the agreements at year-end:		
Carrying value	$ 2,056,165	$ 1,165,125
Estimated fair value	$ 2,165,125	$ 1,261,351

(11) Financial Instruments

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit, standby letters of credit and financial guarantees, interest-rate swaps, and futures contracts. Those instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amount recognized in the consolidated statements of financial condition. The contract or notional amounts of those instruments reflect the extent of the Bank's involvement in particular classes of financial instruments.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit, standby letters of credit, and financial guarantees written is represented by the contractual notional amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. For interest-rate swap transactions, forward and futures contracts, the contract or notional amounts do not represent exposure to credit loss. The Bank controls the credit risk of its interest-rate swap agreements and forward and futures contracts through credit approvals, limits, and monitoring procedures.

Unless noted otherwise, the Bank does not require collateral or other security to support financial instruments with credit risk.

Interest-Rate Exchange Agreements. The Bank enters into a variety of interest-rate swap transactions in managing its interest-rate exposure. Interest-rate swap transactions generally involve the exchange of fixed- and floating-rate interest-payment obligations without the exchange of the underlying principal amounts. Though swaps are also used as part of asset/liability management, most of the interest-rate swap activity arises when the Bank acts as an intermediary in arranging interest-rate swap transactions for customers. The Bank typically becomes a principal in the exchange of interest payments between the parties and, therefore, is exposed to loss should one of the parties default. The Bank minimizes this risk by performing normal credit reviews on its swap customers and minimizes its exposure to the interest-rate risk inherent in intermediated swaps by entering into offsetting swap positions that essentially counterbalance each other.

Entering into interest-rate swap agreements involves not only the risk of dealing with counterparties and their ability to meet the terms of the contracts but also the interest-rate risk associated with unmatched positions. Notional principal amounts often are used to express the volume of these transactions, but the amounts potentially subject to credit risk are much smaller.

During 19X2 and 19X1, the Bank entered into agreements to assume fixed-rate interest payments in exchange for variable market-indexed interest payments (interest-rate swaps). The notional principal amounts of interest-rate swaps outstanding were $500,000 and $300,000 at December 31, 19X2 and 19X1, respectively. The original terms are all three years. The weighted-average fixed-payment rates were 8.00 percent and 8.10 percent at December 31, 19X2 and 19X1, respectively. Variable-interest payments received are based on 90-day commercial paper. At December 31, 19X2, the weighted-average rate of variable market-indexed interest payment obligations to the Bank was 7.95 percent. The effect of these agreements was to lengthen short-term variable-rate liabilities into longer-term fixed-rate liabilities. The net costs of these agreements were $15,000 and $25,000 for the years ended December 31, 19X2 and 19X1, respectively, which were amortized to income.

Financial Futures. Futures contracts are contracts for delayed delivery of securities or money-market instruments in which the seller agrees to make delivery at a specified future date of a specified instrument at a specified price or yield. Risks arise from the possible inability of counterparties to meet the terms of their contracts and from movements in securities values and interest rates.

The Bank uses financial futures contracts to hedge interest-rate exposure generally on secondary mortgage market operations. Short futures positions held in Treasury note contracts at December 31, 19X2, were $200,000. No positions were held at, or during the year ended, December 31, 19X1. The net unrealized loss paid on maintenance of margin deposits relating to open positions was $14,344 at December 31, 19X2. Net unamortized gains on positions closed during 19X2 were $12,983.

The cost of U.S. Treasury bills pledged as collateral for initial margin on open futures contracts was $50,000 at December 31, 19X2.

Commitments to Extend Credit and Financial Guarantees. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank's experience has been that approximately 60 percent of loan commitments are drawn upon by customers. While approximately 90 percent of commercial letters of credit are utilized, a significant portion of such utilization is on an immediate payment basis. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if it is deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable; inventory, property, plant, and equipment; and income-producing commercial properties.

Standby letters of credit and financial guarantees written are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing, and similar transactions. Except for short-term guarantees of approximately $250,000, most guarantees extend for more than five years and expire in decreasing amounts through 20XX. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank holds marketable securities as collateral supporting those commitments for which collateral is deemed necessary. The extent of collateral held for those commitments at December 31, 19X2, varies from 5 percent to 10 percent; the average amount collateralized is 9 percent.

The Bank has not been required to perform on any financial guarantees during the past two years. The Bank has not incurred any losses on its commitments in either 19X2 or 19X1.

The estimated fair values of the Bank's financial instruments were as follows at:

	December 31, 19X2:		December 31, 19X1:	
	Carrying Amount	*Fair Value*	*Carrying Amount*	*Fair Value*
Financial assets:				
Cash and due from banks, interest-bearing deposits with banks, and federal funds sold	$ 8,564,994	$ 8,564,994	$ 7,093,212	$ 7,093,212
Securities purchased under agreements to resell	875,326	876,413	0	0
Trading securities	30,374	30,374	30,118	30,118
Securities available for sale	6,148,700	6,148,700	5,045,456	5,045,456
Securities held to maturity	2,049,566	2,089,972	1,681,818	1,657,859
Loans receivable	27,076,985	27,132,621	26,731,035	26,852,930
Accrued interest receivable	312,873	312,873	305,226	305,226
Customers' liabilities on acceptances	85,569	85,569	55,725	55,725
Loans held for sale	931,962	931,962	860,454	860,454
Excess servicing receivables	1,143,692	1,143,692	994,225	994,225
Financial liabilities:				
Deposit liabilities	(41,513,954)	(42,031,563)	(38,393,921)	(38,856,321)
Short-term borrowings	(3,579,881)	(3,745,006)	(2,492,359)	(2,753,710)
Long-term debt	(330,740)	(332,288)	(343,461)	(351,232)
Off-balance-sheet assets (liabilities):				
Commitments to extend credit		(47,122)		(45,132)
Credit card arrangements		(1,392)		(1,862)
Commercial letters of credit		(2,034)		(1,915)
Standby letters of credit		(4,735)		(4,815)
Interest rate swaps in a net payable position		(2,156)		(1,032)

A summary of the notional amounts of the Bank's financial instruments with off-balance-sheet risk at December 31, 19X2, follows:

	Notional Amount
Commitments to extend credit	$560,000
Interest-rate swaps	500,000
Credit card arrangements	12,000
Commercial letters of credit	25,000
Standby letters of credit	50,000

(12) Significant Group Concentrations of Credit Risk

Most of the Bank's business activity is with customers located within the state. Investments in state and municipal securities involve governmental entities within the Bank's market area. As of December 31, 19X2, the Bank's receivables from, guarantees of, and obligations of companies in the semiconductor industry were $8.4 million. As of December 31, 19X2, the Bank also was creditor for $1.2 million of domestic loans and other receivables from companies with high debt-to-equity ratios as a result of buyout transactions. Generally, the loans are secured by assets or stock. The loans are expected to be repaid from cash flow or proceeds from the sale of selected assets of the borrowers. Credit losses arising from lending transactions with highly leveraged entities compare favorably with the Bank's credit loss experience on its loan portfolio as a whole. The Bank's policy for requiring collateral is **[Note: The institution should state its policy, along with information about the entity's access to that collateral or other security and a description of collateral].**

The distribution of commitments to extend credit approximates the distribution of loans outstanding. Commercial and standby letters of credit were granted primarily to commercial borrowers. The Bank, as a matter of policy, does not extend credit in excess of $500,000 to any single borrower or group of related borrowers.

The contractual amounts of credit-related financial instruments such as commitments to extend credit, credit-card arrangements, and letters of credit represent the amounts of potential accounting loss should the contract be fully drawn upon, the customer default, and the value of any existing collateral become worthless. **[Note: The institution may also disclose the likelihood that these contracts will be drawn upon, expected future liquidity requirements, and its policies for evaluating the creditworthiness of counterparties and requiring collateral.]**

(13) Income Taxes

The Bank and Subsidiary file consolidated federal income tax returns on a calendar-year basis. If certain conditions are met in determining taxable income, the Bank is allowed a special bad debt deduction based on a percentage of taxable income (presently 8 percent) or on specified experience formulas. The Bank used the percentage-of-taxable-income method in 19X1 and anticipates using the same method in 19X2.

The consolidated provision for income taxes consisted of the following for the years ended December 31:

	19X2	*19X1*
Current tax provision:		
Federal	$ 119,392	$ 90,967
State	1,676	3,189
	121,068	94,156
Deferred federal	4,470	15,211
	$ 125,538	$ 109,367

The reasons for the differences between the statutory federal income tax rates and the effective tax rates are summarized as follows.**

	19X2	*19X1*
Statutory rates	34.0%	34.0%
Increase (decrease) resulting from:		
Effect of tax-exempt income	-14.2%	-15.3%
Dividends received deduction	- 0.5%	- 0.5%
Interest and other nondeductible expenses	0.7%	0.9%
Other, net	- 0.5%	0.0%
	19.5%	19.1%

** This table would be required only if the institution was a public enterprise (see paragraph 47 of FASB Statement No. 109, *Accounting for Income Taxes*).

Deferred tax assets and liabilities included in other assets at December 31 consist of the following:

	19X2	*19X1*
Deferred tax assets:		
Allowance for loan losses	$ 30,409	$ 31,275
Deferred loan fees	3,968	5,026
	34,377	36,301
Deferred tax liabilities:		
Accumulated depreciation	(18,320)	(16,156)
Net unrealized appreciation on available-for-sale securities	(1,728)	(1,832)
Other	(1,110)	(728)
	(21,158)	(18,716)
Net deferred tax asset	$ 13,219	$ 17,585

(14) Related Parties

The Bank has entered into transactions with its directors, significant shareholders, and their affiliates (related parties). The aggregate amount of loans to such related parties at December 31, 19X2, was $443,850. During 19X2, new loans to such related parties amounted to $127,400 and repayments amounted to $122,100.

(15) Commitments and Contingencies

In the ordinary course of business, the Bank has various outstanding commitments and contingent liabilities that are not reflected in the accompanying consolidated financial statements. In addition, the Bank is a defendant in certain claims and legal actions arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, the ultimate disposition of these matters is not expected to have a material adverse effect on the consolidated financial condition of the Bank.

(16) Restrictions on Retained Earnings

The Bank is subject to certain restrictions on the amount of dividends that it may declare without prior regulatory approval. At December 31, 19X2, approximately $635,000 of retained earnings were available for dividend declaration without prior regulatory approval.

(17) Regulatory Matters

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 19X2, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 19X2, the most recent notification from the Office of the Comptroller of the Currency categorized the Bank as adequately capitalized under the regulatory framework for prompt corrective action. To be categorized as adequately capitalized the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

The Bank's actual capital amounts and ratios are also presented in the table. Totals of $91,322 and $81,325 were deducted from capital for interest-rate risk in 19X2 and 19X1, respectively.

	Actual		*For Capital Adequacy Purposes:*		*To Be Well Capitalized Under Prompt Corrective Action Provisions:*	
	Amount	*Ratio*	*Amount*	*Ratio*	*Amount*	*Ratio*
As of December 31, 19X2:						
Total Capital (to Risk Weighted Assets)	$3,712,382	9.2%	≥$3,228,158	≥8.0%	≥$4,035,198	≥10.0%
Tier I Capital (to Risk Weighted Assets)	$3,066,750	7.6%	≥$1,614,079	≥4.0%	≥$2,421,119	≥6.0%
Tier I Capital (to Average Assets)	$3,066,750	6.8%	≥$1,803,971	≥4.0%	≥$2,254,964	≥5.0%
As of December 31, 19X1:						
Total Capital (to Risk Weighted Assets)	$3,518,931	9.1%	≥$3,093,566	≥8.0%	≥$3,866,957	≥10.0%
Tier I Capital (to Risk Weighted Assets)	$2,861,548	7.4%	≥$1,546,783	≥4.0%	≥$2,320,174	≥6.0%
Tier I Capital (to Average Assets)	$2,861,548	6.6%	≥$1,734,272	≥4.0%	≥$2,167,839	≥5.0%

Under the framework, the Bank's capital levels do not allow the Bank to accept brokered deposits without prior approval from regulators. **[Note: Describe the possible effects of this restriction.]**

Appendix A

Background Information and Basis for Conclusions

Introduction

A-1. In August 1994, an exposure draft of a proposed Audit and Accounting Guide *Banks and Savings Institutions* was issued for public comment. This appendix provides background information on the project and summarizes conclusions the AICPA Banking and Savings Institutions Committees (the committees) reached on significant provisions resulting in the final Guide. Included are the committees' considerations of the merits of significant comments received.

Background Information

A-2. In March 1993, the Financial Accounting Standards Board (FASB) did not object to a project to combine and revise the AICPA Industry Audit Guide *Audits of Banks* with the AICPA Audit and Accounting Guide *Audits of Savings Institutions*. The prospectus asserted that, before 1993, the most significant differences in general purpose financial statements of banks and savings institutions related to accounting for troubled loans and investments in debt and equity securities. The FASB resolved these differences through subsequent pronouncements. Additional perceived accounting differences were identified during development and exposure of the Guide and have been eliminated through issuance of the Guide.

A-3. The project excluded the AICPA Audit and Accounting Guide *Audits of Credit Unions* from the scope of the project because such a combined Guide would include extensive discussions of matters not related to credit unions. Those matters include (among others) certain investing, lending, and other activities prohibited of credit unions; income tax matters; and regulatory matters, including the audit and attestation requirements of the Federal Deposit Insurance Corporation Improvement Act (FDICIA).

Status of Audit and Accounting Guides in the GAAP Hierarchy

A-4. Several respondents to the exposure draft said it would be inappropriate for the Guide to establish generally accepted accounting principles (GAAP). The committees note that AICPA Industry Audit and Accounting Guides are recognized in Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), as a source of established accounting principles. SAS No. 69 describes the hierarchy of sources of established accounting principles that are generally accepted in the United States.

Scope

A-5. The Preface states that the Guide applies to the preparation and audit of financial statements of entities supervised by the federal banking regulatory agencies.[1] That population includes:

- Depository institutions insured by the FDIC's Bank Insurance Fund (BIF) or Savings Association Insurance Fund (SAIF), whatever the institution's charter.
- Bank holding companies.
- Savings and loan association holding companies.
- Branches and agencies of foreign banks.

A-6. The Preface states further that the guidance also applies to preparation and audit of financial statements of:

a. State-chartered banks and savings institutions not insured by the FDIC's BIF or SAIF.

b. Foreign banks to the extent those financial statements are purported to be prepared in conformity with accounting principles (or audited in accordance with auditing standards) generally accepted in the United States.

A-7. Most respondents agreed with the scope proposed in the exposure draft, but some pointed out that the proposed scope might be interpreted too broadly (for example, to include lending activities of commercial enterprises). The committees decided the Guide's scope sufficiently describes the types of institutions covered. The scope reflects the committees' view that the accounting and auditing issues addressed are not unique to whether a bank or savings institution is federally insured. The committees believe the application of guidance by institutions within the Guide's scope will promote the comparability of financial reporting within the industry.

Materiality

A-8. Several respondents said certain requirements proposed in the exposure draft should be deleted because the related activities or transactions were immaterial to the respondents' financial statements. FASB Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information,* discusses materiality as a qualitative characteristic of accounting information. Because the concept of materiality is implicit in accounting information, the committees did not consider respondents' recommendations based solely on materiality.

Income Recognition for Impaired Loans

A-9. Chapters 6 and 7 of the Guide address income recognition for impaired loans by referring readers to FASB Statement of Financial Accounting Standards No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures.* Also, the "Regulatory Matters" sections of those chapters discuss the Federal Financial Institutions Examination Council (FFIEC's) February 1995 action, which addresses income recognition for regulatory financial reporting purposes.

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[1] The federal banking regulatory agencies are the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) (collectively, the agencies).

A-10. Issued in October 1994, FASB Statement No. 118 amended FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, to allow creditors to use existing methods for recognizing interest income on an impaired loan. To accomplish that, FASB Statement No. 118 eliminated the provisions of FASB Statement No. 114 that describe how creditors should report income on impaired loans. FASB Statement No. 118 did not change the provisions in FASB Statement No. 114 that require creditors to measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the observable market price of the loan or the fair value of the collateral if the loan is collateral-dependent.

A-11. Most respondents suggested the Guide incorporate the provisions of FASB Statement No. 118. Some of those respondents suggested the Guide also provide examples of FASB Statement No. 118's application. Other suggestions included adopting regulatory standards for income recognition, restoring the income recognition provisions of existing Guides, creating a new income recognition method, or illustrating various proposed or existing methods.

A-12. The committees decided against recommendations that would involve providing income recognition guidance beyond that contained in (*a*) FASB Statements No. 114 or No. 118 or (*b*) guidance for regulatory financial reporting. Before 1992, an Accounting Standards Executive Committee (AcSEC) task force had a project to develop an issues paper on financial reporting (by financial institutions) of interest income on troubled or past-due loans. In January 1992, AcSEC tabled the project in recognition that the FASB's financial instruments project would consider related issues, including the impairment of loans and present-value-based measurements of accounting. In a 1993 letter of comment on the exposure draft that preceded FASB Statement No. 118, AcSEC said:

> How and when a creditor should measure and report interest income on impaired loans is an important issue. That issue is less critical, however, than the impairment issue resolved by FASB Statement No. 114 and can be addressed in due course. The Board could resume consideration of income recognition in future sections of the overall financial instruments project or in the continuing project on present-value-based measurements.

A-13. The committees also decided against illustrating the application of various income recognition methods at this time. FASB Statement No. 118 does not address how a creditor should recognize, measure, or display interest income on an impaired loan. The committees believe illustrating various income recognition methods would imply that illustrated methods were preferable to other methods.

Loan Accounting

Management's Intent and Ability

A-14. Paragraph 6.45 of the Guide refers to management's intent and ability to hold loans as a justification for amortized-cost accounting. Specifially, paragraph 6.45 carries forward the requirements set forth in paragraph 6.20 of *Audits of Savings Institutions* (May 1994) and otherwise captures practice.[2]

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[2] Paragraph 19.17 of *Audits of Banks* (May 1994) says:
[If] at the end of a reporting period it is apparent that a bank intends to sell certain loans and the anticipated sale will result in a loss, the bank generally establishes an allowance for losses, which is deducted from the related asset in the balance sheet.

A-15. Some respondents suggested that paragraph 6.45 establishes a new accounting principle. Others suggested that, unless an institution has a "positive intent to sell" loans, those loans should be recorded at their amortized cost. The committees believe, instead, that the use of amortized cost for loans should continue to be justified based on the management's intent and ability to hold those loans for the foreseeable future or until maturity or pay-off.

A-16. Paragraph 4 of FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, requires that a mortgage loan shall not be classified as a long-term investment unless the mortgage banking enterprise has both the ability and intent to hold the loan for the foreseeable future or until maturity. The committees believe that, though FASB Statement No. 65 applies to mortgage loans, this approach also should be applied to all loans.

A-17. For example, the committees point to incorporation of such an approach in regulatory policy. Specifically, the section "Reporting of Loans Held for Sale or Trading" of the FFIEC's *Supervisory Policy Statement on Securities Activities*, says:

> Historically, depository institutions have tended to hold loans until maturity. Consequently, the application of lower of cost or market value accounting to portions of the loan portfolio has not been an issue except in those depository institutions that have regularly originated or purchased loans for purposes of subsequent sale. Nevertheless, as with debt securities, *reporting loans at the lower of cost or market value is required when the institution does not have both the intent and ability to hold these loans for long-term investment purposes*. [Emphasis added.]

Allowance for Loan Losses

A-18. Chapter 7 of the Guide says that liabilities related to credit losses associated with off-balance-sheet financial instruments should be reported separately as liabilities and not as part of the allowance for loan losses. Off-balance-sheet financial instruments include commitments to extend credit, guarantees, and standby letters of credit, and also futures, forward, swap, option, and other contracts with similar characteristics. Some respondents questioned this guidance. They said banks and savings institutions view the allowance for loan losses as also available for credit losses arising from other financial instruments. Despite the requirement for separate financial reporting, chapter 7 acknowledges that management often considers credit risk associated with such off-balance-sheet financial instruments at the same time it considers credit risk associated with the loan portfolio. The committees further acknowledge the practice of some banks and savings institutions to assess exposure to the aggregate credit risk posed by all transactions with one counterparty. However, financial reporting of on- and off-balance-sheet financial instruments is not currently accomplished through classification and presentation of such instruments by counterparty. Further, paragraph 92 of FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, says:

> The Board believes that generally accepted accounting principles proscribe inclusion of an accrual for credit loss on a financial instrument with off-balance-sheet risk in a valuation account (allowance for loan losses) related to a recognized financial instrument.

Derivative Financial Instruments

A-19. In October 1994, the FASB issued FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*. In December 1994, the AICPA issued *Derivatives—Current Accounting and Auditing Literature*, a report prepared by AcSEC's Financial Instruments Task Force and representatives of the Auditing Standards Board (ASB).

A-20. As suggested by various respondents, the "Accounting and Financial Reporting" section in chapter 15 includes reference to the provisions of FASB Statement No. 119, and the "Introduction" and "Auditing" sections in chapter 15 have been revised to reflect refinements made in the AICPA's derivatives report.

A-21. Paragraph 15.83 omits proposals in the exposure draft that would have required certain disclosures about option and swap contracts. The committees agreed with respondents who said FASB Statement No. 119 appropriately addresses the related matters.

Miscellaneous Disclosure Requirements

Repurchase and Reverse-Repurchase Agreements

A-22. In 1986, the AICPA issued Statement of Position (SOP) 86-1, *Reporting Repurchase—Reverse Repurchase Agreements and Mortgage-Backed Certificates by Savings and Loan Associations*. SOP 86-1 was incorporated in and superseded by the 1991 revision of *Audits of Savings Institutions*. The FASB subsequently issued the following related pronouncements:

- FASB Statement No. 105, which requires disclosures about credit and market risks.
- FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, which requires disclosures about the fair value of financial instruments, including repurchase and reverse repurchase agreements.

A-23. The exposure draft proposed that the disclosure requirements previously required of savings institutions be required equally of banks. Included were certain (*a*) end-of-period disclosures and (*b*) disclosures about the maximum month-end and average amounts of outstanding agreements during the period and control of collateral. Paragraph 12.34 of the Guide omits the end-of-period disclosures proposed in the exposure draft. The committees agreed with respondents who pointed out that those proposed disclosures effectively have been superseded by the requirements of FASB Statements No. 105 and No. 107. The committees agreed with several respondents' observations that the proposed disclosures were disproportionate in comparison to disclosures for other short-term borrowings or investments. The committees decided, however, that the proposed disclosures about the maximum month-end and average amounts of outstanding agreements during the period (and the basis for averaging) and about control of collateral provide important information about the extent of leveraging of such transactions and credit risk, respectively. These disclosures were not within the proposed or final scope of FASB Statements No. 105 or No. 107 and the committees believe the information continues to be relevant for both banks and savings institutions.

Tax Effect Related to Securities Gains and Losses

A-24. The Guide omits an exposure draft proposal that would have required banks and savings institutions to disclose the amount of tax effect related to realized gains and losses on sales of securities. The FASB deliberated disclosures about securities and tax matters in completing FASB Statements No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and No. 109, *Accounting for Income Taxes*, respectively. Those Statements apply to all types of entities. Many respondents said requiring the disclosure would, in effect, arbitrarily supplement the disclosure requirements of FASB Statements No. 109 and No. 115 by extending a Securities and Exchange Commission (SEC) disclosure requirement to non-SEC-registrants in one industry. The committees agree with those respondents.[3]

Trust Services and Activities

A-25. The scope of chapter 17 on trust services and activities is consistent with that proposed in the exposure draft. Some respondents suggested that the scope be expanded to provide guidance on proprietary mutual funds, servicing loans for others, securities settlement, custodial services, and similar activities. The committees will consider whether to propose developing guidance on such matters as a future project.

Disclosures About Regulatory Matters

General

A-26. One uncertainty faced by banks and savings institutions is the potential for regulatory action, in part, as a result of capital adequacy requirements and through the prompt corrective action framework established in Section 38 of the Federal Deposit Insurance Act (FDI Act). The agencies use capital adequacy guidelines and the framework as tools to monitor the financial health of insured institutions.

A-27. FASB Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises,* says financial reporting should "provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions" (paragraph 34). To support that decision-making process, financial reports should help such users "assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise" (paragraph 37) by providing "information about the economic resources of an enterprise, the claims to those resources, . . . and the effects of transactions, events, and circumstances that change resources and claims to those resources" (paragraph 40). AICPA SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, refers to these objectives saying "without additional disclosure in financial reports about significant risks and uncertainties, these objectives may not be fully met in today's environment" (paragraph B-1). The Guide's required disclosures about such regulatory matters help satisfy these objectives.

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[3] The disclosure is required for SEC registrants by Rule 9-04.13(h) of Article 9 of Regulation S-X.

Quantitative Disclosures

A-28. Many respondents commented on the detailed quantitative disclosures proposed in the exposure draft. Many suggested that the financial statements of banks and savings institutions would be burdened by the proposed disclosures. Among other concerns, respondents suggested that including the proposed quantitative disclosures in audited financial statements might (*a*) obscure the articulation of uncertainty related to regulators' qualitative judgments or (*b*) cast doubt on the appropriateness of accounting principles used for equity amounts in the general purpose financial statements.[4] These concerns are outweighed by the usefulness of the quantitative information (including information for significant subsidiaries of holding companies) to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions.

Prompt Corrective Action

A-29. The Guide explains that compliance by a bank or savings institution with provisions of the prompt corrective action framework involves both qualitative and quantitative factors. Qualitative measures include regulators' judgments about components of capital, risk weightings, and other factors. Quantitative measures involve relationships between three separate ratios of specified capital amounts to specified asset amounts. Certain institutions also are required to deduct (from capital) amounts for interest-rate risk, concentrations of credit risk, and risks of nontraditional activities (as defined).

A-30. The committees decided, because of the importance of regulatory oversight of banks and savings institutions through the framework, that adding related requirements for disclosure of the institution's capital category within the framework and management's assertion about whether any conditions or events have changed the institution's capital category would improve the relevance and usefulness of institutions' financial statements, consistent with the objectives of FASB Concepts Statement No. 1.

Auditability and Related Costs

A-31. Respondents suggested that the proposed disclosures would be difficult to audit, too costly to audit, or unauditable.[5] Some believed that, because independent accountants are not trained in the complexities and subjectivity of capital matters and related regulatory financial reporting, resulting audit costs would be excessive. Others suggested that, to adequately assess the disclosures, an independent auditor would need a regulator's representations about capital determinations. Still others suggested the dynamic nature of capital regulations would complicate auditing of the proposed disclosures. Some respondents added that capital regulations often require legal interpretations beyond the competence of an independent auditor.

A-32. The committees believe the expected benefits of these disclosures required by the Guide (including information for significant subsidiaries of holding companies) will exceed related costs.

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[4] Many respondents raised similar concerns as reasons the disclosure requirements should not apply to significant subsidiaries of holding companies.

[5] See footnote 4 in this appendix.

A-33. Also, the committees believe the auditing guidance in paragraphs 2.103 through 2.110 provides an appropriate basis for assessing management's assertion about the conditions or events that have changed the institution's capital category. With respect to disclosures about capital categories, a bank or savings institution is (under federal regulations) deemed to be within a given capital category as of the most recent date (*a*) the institution filed a regulatory financial report,[6] (*b*) a final regulatory examination report is delivered to the institution, or (*c*) the institution's primary regulator provides written notice of the institutions' capital category or that the institution's capital category has changed. The committees believe this actual or deemed notification of an institution's capital category provides an objective and cost-effective basis for preparing and auditing the related disclosures.

A-34. The committees disagree with suggestions that regulatory accounting and capital matters are beyond the competence of independent accountants. General competence with regulatory accounting practices (RAP) is brought to bear by independent accountants in making judgments such as those required by SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, sec. 341), and Issue No. 85-44, *Differences between Loan Loss Allowances for GAAP and RAP,* as discussed by the FASB's Emerging Issues Task Force (EITF). The subjectivity and changing nature of RAP are no less comprehensible than those of GAAP. Also, in the event legal interpretations are necessary, SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), provides guidance to the auditor on the use of attorneys or other specialists.

Permissibility

A-35. Some respondents to the exposure draft of the Guide questioned whether disclosure of an institution's capital category is permissible under regulations implementing the prompt corrective action framework. Those regulations say that "unless permitted by [the institution's primary regulator] or otherwise required by law, no [bank or savings institution] may state in any advertisement or promotional material its capital category under this subpart or that [the institution's primary regulator] or any other federal banking agency has assigned the [bank or savings institution] a particular capital category."[7] The Guide, however, requires disclosure only in the financial statements prepared in conformity with GAAP.

Other Comments

A-36. Some respondents suggested that audited disclosures about regulatory matters are unnecessary because sufficient information is available in independent accountants' reports through paragraph 10 of SAS No. 59. SAS No. 59, in part, requires certain modifications of independent accountants' reports or disclosures in circumstances where there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. The committees decided, however, that the Guide's required disclosures add value by going beyond those matters to be disclosed once there is substantial doubt about an institution's ability to continue as a going concern.

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[6] Regulatory financial reports include FFIEC Consolidated Reports of Condition and Income (call reports) and OTS Thrift Financial Reports.

[7] See Title 12 of the Code of Federal Regulations (12 CFR) Parts 6.1(e), 208.30(e), and 325.101(e).

A-37. Some respondents said the disclosures were not needed because adequate information is available in regulatory financial reports. They added that such reports already are scrutinized by the agencies. Other respondents said it is apparent regulators do not want independent assurance about regulatory financial information because they have not required such assurance as permitted by Section 36(g)(2) of the FDI Act. The committees decided to require disclosures about regulatory matters in audited, general purpose financial statements primarily to benefit the broader population of users of those financial statements. Users of the financial statements of banks and savings institutions include, but are not restricted to, the agencies.

A-38. The majority of respondents said that institutions should be subject to the disclosure requirements without regard to capital status.

Directors' Examinations

A-39. The exposure draft appendix entitled "Suggested Guidelines for CPA Participating in Bank Directors' Examinations" has been omitted from the Guide. The committees are studying the need for changes in related guidance due to changes in legal requirements and professional standards.

A-40. For agreed-upon procedures engagements related to management assertions about the entity's compliance, the independent accountant should consult AICPA Statements on Standards for Attestation Engagements (SSAEs) No. 3, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1, AT sec. 500), as amended by SSAE No. 4, *Agreed-Upon Procedures* (AICPA, *Professional Standards*, vol. 1, AT sec. 600).

A-41. For agreed-upon procedures engagements related to management assertions about the entity's internal control structure over financial reporting, the independent accountant should consult SSAE No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* (AICPA, *Professional Standards*, vol. 1, AT sec. 400), as amended by SSAE No. 4 and SSAE No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2* (AICPA, *Professional Standards*, vol. 1, AT sec. 400). SSAE No. 6 conforms the description of elements of an entity's internal control to the components of internal control contained in SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), and the *Internal Control—Integrated Framework* published by the Committee of Sponsoring Organizations of the Treadway Commission. SSAE No. 6 is effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, with earlier application permitted.

A-42. As discussed in a footnote to the exposure draft appendix, the ASB issued (in late 1994) an exposure draft that has been issued in final form as SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*, vol. 1, AU sec. 622), and supersedes SAS No. 35.

A-43. Independent accountants should consult SSAE No. 4 for other agreed-upon procedures engagements.

Appendix B

Examples of Accounting for Dollar Agreements*

Fixed Coupon

Accounting by Seller-Borrower

Facts

A financial institution owns an 8 percent Government National Mortgage Association (Ginnie Mae) mortgage-backed security (MBS), pool no. 12345, purchased at 100 (face amount) during November 19X6. It agrees to sell this certificate (face amount of $987,436) on January 15, 19X9, at its market value (80) and concurrently agrees to repurchase on May 13, 19X9, an 8 percent Ginnie Mae MBS (face amount of $987,436) at a price of $80^{27}/_{32}$. The seller and buyer agree that "good delivery" of the 8 percent Ginnie Mae MBS on the repurchase date will occur if the principal amount is within 2.5 percent (plus or minus) of the $987,436. For the sake of simplicity, this example assumes no paydown of principal.

January 15, 19X9

Cash	$ 793,021	
Interest income on investment in Ginnie Mae MBS ($987,436 × 8% × $^{14}/_{360}$)		$ 3,072
Funds borrowed ($987,436 × 80)		789,949

To record amounts received under dollar agreement and interest earned from January 1, 19X9, to January 15, 19X9.

Summary of Monthly Journal Entries Recorded During the 120-Day Agreement Period

Interest expense on funds borrowed ($987,436 × 8% × $^{120}/_{360}$)	$ 26,332	
Interest income on investment in Ginnie Mae MBS		$ 26,332

To record normal interest income/expense on 8 percent Ginnie Mae MBS sold under dollar agreement.

Interest expense on funds borrowed [$987,436 × ($80^{27}/_{32}$ – 80)]	$ 8,331	
Accrued interest payable		$ 8,331

To record differential in price as additional interest expense.

* In October 1995, the FASB issued a proposed Statement, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The proposed Statement would significantly affect accounting for (including disclosures about) repurchase agreements. Comments on the proposed Statement were due in January 1996. Readers should be alert to any final pronouncement.

May 13, 19X9

Assumption A

Assume return of an 8 percent Ginnie Mae MBS, pool no. 23451, with a current face amount of $1,004,878 (within the 2.5 percent range for "good delivery"), which is greater than the original principal amount.

Investment in 8 percent Ginnie Mae MBS, pool no. 23451 (new), $987,436 + [($1,004,878 – $987,436) × 80 $^{27}/_{32}$]	$1,001,537	
Accrued interest receivable ($1,004,878 × 8% × $^{12}/_{360}$)	2,680	
Investment in 8% Ginnie Mae MBS, pool no. 12345 (old)		$987,436
Cash (increment in certificate basis)		16,781

To record additional principal of 8 percent Ginnie Mae MBS, pool no. 23451, and interest earned from May 1, 19X9, to May 13, 19X9.

Funds borrowed	$ 789,949	
Accrued interest payable	8,331	
Cash		$798,280

To record repayment of funds borrowed.

Assumption B

Assume return of an 8 percent Ginnie Mae MBS, pool no. 23452, with a current face amount of $972,625 (within the 2.5 percent range for "good delivery"), which is less than the original principal amount.

Investment in 8% Ginnie Mae MBS pool no. 23452 (new)	$ 972,625	
Accrued interest receivable ($972,625 × 8% × $^{12}/_{360}$)	2,594	
Loss on sale of investment in Ginnie Mae MBS, 8% pool no. 12345 [$14,800 × (100 – 80)]	2,962	
Funds borrowed	14,811	
Accrued interest payable [14,811 × (80 $^{27}/_{32}$ – 80)]	124	
Interest income on Ginnie Mae MBS investment ($14,811 × 8% × $^{120}/_{360}$)	396	
Investment in 8% Ginnie Mae MBS pool no. 12345 (old)		$987,436
Interest expense on funds borrowed ($124 + $396)		520
Cash		5,556

To record purchase of 8 percent Ginnie Mae MBS, pool no. 23452, sale of 8 percent Ginnie Mae MBS, pool no. 12345, and reduction of funds borrowed on January 15, 19X9. *Note:* The reduction in basis ($987,436 – $972,625 = $14,811) between the old certificate and the new certificate is used to determine the amount of loss recognition and to adjust the following accounts: funds borrowed, accrued interest, and interest income as established on January 15, 19X9, and during the 120-day period ended May 13, 19X9.

Funds borrowed ($789,949 – $14,811)	$775,138	
Accrued interest payable ($8,331 – $124)	8,207	
Cash		$783,345

To record repayment of funds borrowed.

Summary of Cost of Borrowed Funds

Assumption A

Interest on 8% Ginnie Mae MBS, pool no. 12345	$ 26,332
Difference between sale and repurchase price (80 $^{27}/_{32}$ – 80)	8,331
Total cost of funds	$ 34,663
Borrowed funds	$789,949

$$\frac{\text{Cost of Funds (\$34,663)}}{\text{Borrowed Funds (\$789,949)}} = .044 \times 3 = 13.2\% \text{ annualized}$$

Assumption B

Interest on 8% Ginnie Mae MBS, pool no. 12345	$ 26,332
Difference between sale and repurchase price (80 $^{27}/_{32}$ – 80)	8,331
Interest expense adjustment due to reduction in basis	(520)
Total cost of funds	$ 34,143
Initial borrowed funds	$789,949
Less partial sale of 8% Ginnie Mae MBS, pool no. 12345	(14,811)
Actual borrowed funds	$775,138

$$\frac{\text{Cost of Funds (\$34,143)}}{\text{Borrowed Funds (\$775,138)}} = .044 \times 3 = 13.2\% \text{ annualized}$$

Yield Maintenance

Accounting by Seller-Borrower

Facts

A financial institution owns a 9.5 percent Ginnie Mae MBS, pool no. 34621, purchased at 97 during August 19X8. It agrees to sell this certificate (face amount of $992,925) on January 15, 19X9, at its market value (86 $^{22}/_{32}$) and concurrently agrees to repurchase a 9.5 percent Ginnie Mae MBS (face amount of $992,925) on May 13, 19X9, at 88 to yield 11.34 percent. The seller and buyer agree that "good delivery" of the Ginnie Mae MBS on the repurchase date will occur if the principal amount is within 2.5 percent (plus or minus) of the $992,925. They further agree that if the Federal Housing Administration (FHA) or Department of Veterans' Affairs (VA) mortgage rate changes during the four-month period, the buyer may deliver on the repurchase date a Ginnie Mae MBS bearing the new current interest rate at a price to produce the above yield of 11.34 percent; however, such price shall not exceed par (yield-maintenance agreement with a par cap). For the sake of simplicity, this example assumes no paydown of principal.

January 15, 19X9

Cash	$ 864,410	
Loss on sale of investment in 9.5% Ginnie Mae MBS, pool no. 34621	102,395	
Unearned discount	29,788	
Investment in 9.5% Ginnie Mae MBS, pool no. 34621		$ 992,925
Interest income on investment in Ginnie Mae MBS ($992,925 × 9.5% × 14/360)		3,668

To record sale of 9.5 percent Ginnie Mae MBS, pool no. 34621, in connection with yield-maintenance agreement and interest earned from January 1, 19X9, to January 15, 19X9.

Note:

Face amount	$ 992,925
Cost (97)	963,137
Unearned discount	$ 29,788
Market January 15, 19X9 ($992,925 × 86 22/32)	$ 860,742
Loss ($963,137 – $860,742)	$ 102,395

May 13, 19X9

Assumption A

Assume the FHA or VA mortgage rate did not change during the four-month period of the agreement and a 9.5 percent Ginnie Mae MBS, pool no. 18960, with a current face amount of $989,650 (within the 2.5 percent range for "good delivery") is delivered to the seller-borrower.

Investment in 9.5% Ginnie Mae MBS, pool no. 18960 ($989,650 × 88)	$ 870,892	
Accrued interest receivable ($989,650 × 9.5% × 12/360)	3,133	
Cash		$ 874,025

To record purchase of 9.5 percent Ginnie Mae MBS, pool no. 18960, and accrued interest from May 1, 19X9, to May 13, 19X9.

Assumption B

Assume the FHA or VA mortgage rate did change during the four-month period of the agreement and delivery is made with an 11 percent (current Ginnie Mae MBS interest rate) Ginnie Mae MBS, pool no. 48650, with a current face amount of $998,875 (within the 2.5 percent range for "good delivery") priced at 97 $^{12}/_{32}$ to provide the agreed yield of 11.34 percent.

Investment in 11% Ginnie Mae MBS, pool no. 48650 ($998,875 × 97 $^{12}/_{32}$)	$ 972,655	
Accrued interest receivable ($998,875 × 11% × $^{12}/_{360}$)	3,662	
Cash		$ 976,317

To record purchase of 11% Ginnie Mae MBS, pool no. 48650, and accrued interest from May 1, 19X9, to May 13, 19X9.

Rollover of Extension

Facts

A financial institution entered a four-month fixed-coupon agreement from January 15, 19X9, to May 13, 19X9. On May 13, 19X9, the institution repurchased an 8 percent Ginnie Mae MBS, pool no. 23451, with a face amount of $1,004,878 and a book basis of $1,001,537. The institution accounted for the transaction as a financing and recorded journal entries in the manner previously described in this Appendix. Also on May 13, 19X9, the institution agrees to sell certificate no. 23451 at its market value (81) and agrees to repurchase an 8 percent Ginnie Mae MBS (current face amount of $1,004,878) three months later (90 days) on August 10, 19X9.

May 13, 19X9

Assumption A—Financing Transaction

Assume a fixed-coupon agreement from May 13, 19X9, to August 10, 19X9.

Cash	$ 816,631	
Accrued interest receivable ($1,004,878 × 8% × $^{12}/_{360}$)		$ 2,680
Funds borrowed ($1,004,878 × 81)		813,951

To record amounts received under fixed-coupon agreements, 8% Ginnie Mae MBS, pool no. 23451, from May 13, 19X9, to August 10, 19X9, and interest received for the period May 1, 19X9, to May 13, 19X9.

Assumption B—Sell-Buy

Assume a yield-maintenance agreement from May 13, 19X9, to August 10, 19X9.

Cash	$ 816,631	
Loss on sale of investment in 8% Ginnie Mae MBS, pool no. 23451 [$1,001,537 – ($1,004,878 × 81)]	187,586	
Investment in 8% Ginnie Mae MBS, pool no. 23451		$ 1,001,537
Accrued interest receivable		2,680

To record sale of 8% Ginnie Mae MBS, pool no. 23451, in connection with yield-maintenance agreement from May 13, 19X9, to August 10, 19X9, and interest received for the period May 1, 19X9, to May 13, 19X9.

Appendix C
Illustrative Forms of Confirmation Requests

Negative Loan Confirmation Request
[Sample Institution Letterhead]

[Name and address] *[Date]*

In connection with their examination of our records, please confirm the correctness of the following information directly to our auditors, A.B. & Co., Certified Public Accountants, 100 Main Street, Any City, State, Zip Code.

Our records show that at the close of business on ______*[date]*______ you were indebted to us for $ ________ as follows:

Loan number(s)	______	______	______	______
Balance as of ___*[date]*___	______	______	______	______
Original loan amount	______	______	______	______
Date of loan	______	______	______	______
Due date of loan	______	______	______	______
Interest rate	______	______	______	______
Date to which interest is paid	______	______	______	______
Collateral	______	______	______	______

IF YOUR RECORDS AGREE WITH THE INFORMATION SHOWN, NO REPLY IS NECESSARY.

IF YOUR RECORDS DO NOT AGREE with the information shown, please indicate what you believe to be the correct information, sign in the space provided, and return this letter to our auditors in the enclosed self-addressed, stamped envelope.

Sincerely,

Sample Institution ____________________

By ______________________________

A.B. & Co.:
The above information is not correct. The differences are as follows:

____

____

____

Date ______________________ Signature ______________________

Title ______________________

Note: The CPA should exercise judgment in determining whether all of the indicated information is desired.

Positive Loan Confirmation Request

[Sample Institution Letterhead]

[Name and address] *[Date]*

In connection with their examination of our records, please confirm the correctness of the following information directly to our auditors, A.B. & Co., Certified Public Accountants, 100 Main Street, Any City, State, Zip Code.

Our records show that at the close of business on ____*[date]*____ you were indebted to us for $ ______ as follows:

Loan number(s)	______	______	______	______
Balance as of ___*[date]*___	______	______	______	______
Original loan amount	______	______	______	______
Date of loan	______	______	______	______
Due date of loan	______	______	______	______
Interest rate	______	______	______	______
Date to which interest is paid	______	______	______	______
Collateral	______	______	______	______

IF YOUR RECORDS AGREE with the information shown, please sign in the appropriate space below and return this letter to our auditors in the enclosed self-addressed, stamped envelope.

IF YOUR RECORDS DO NOT AGREE with the information shown, please sign in the appropriate space below, indicate what you believe to be the correct information, and return this letter to our auditors.

Sincerely,

Sample Institution ____________________

By ________________________________

A.B. & Co.:
The above information is correct.

Date ______________________ Signature ____________________

Title ________________________

The above information is not correct. (The exceptions are shown on the reverse side of this letter.)

Date ______________________ Signature ____________________

Title ________________________

Note: The CPA should exercise judgment in determining whether all of the indicated information is desired.

Negative Deposit Confirmation Request*

[*Sample Institution Letterhead*]

[*Name and address*] [*Date*]

In connection with their examination of our records, please confirm the correctness of the following information directly to our auditors, A.B. & Co., Certified Public Accountants, 100 Main Street, Any City, State, Zip Code.

Our records show that at the close of business on ___[*date*]___ the balance in your ___[*type of deposit account*]___ was as follows:

Account number ____________________

Balance ____________________

IF YOUR RECORDS AGREE WITH THE INFORMATION SHOWN, NO REPLY IS NECESSARY.

IF YOUR RECORDS DO NOT AGREE with the information shown, please indicate what you believe to be the correct information, sign in the space provided, and return this letter to our auditors in the enclosed self-addressed, stamped envelope.

Sincerely,

Sample Institution ____________________

By ____________________

A.B. & Co.:
The above information is not correct. The differences are as follows:

____

____

____

Date ____________________ Signature ____________________

Title ____________________

Note to Recipient: This confirmation request pertains ONLY to the account described above and not to any other accounts you may have with the bank as of the date shown above.

* See paragraph 11.42.

Positive Deposit Confirmation Request

[*Sample Institution Letterhead*]

[*Name and address*] [*Date*]

In connection with their examination of our records, please confirm the correctness of the following information directly to our auditors, A.B. & Co., Certified Public Accountants, 100 Main Street, Any City, State, Zip Code.

Our records show that at the close of business on ____[*date*]____ the balance in your ____[*type of deposit account*]____ was as follows:

Account number ____________________

Balance ____________________

IF YOUR RECORDS AGREE with the information shown, please sign in the appropriate space below and return this letter to our auditors in the enclosed self-addressed, stamped envelope.

IF YOUR RECORDS DO NOT AGREE with the information shown, please sign in the appropriate space below, indicate what you believe to be the correct information, and return this letter to our auditors.

Sincerely,

Sample Institution ____________________

By ____________________

A.B. & Co.:
The above information is correct.

Date ____________________ Signature ____________________
Title ____________________

The above information is not correct. (The exceptions are shown on the reverse side of this letter.)

Date ____________________ Signature ____________________
Title ____________________

Note to Recipient: This confirmation request pertains ONLY to the account described above and not to any other accounts you may have with the bank as of the date shown above.

General Purpose Negative Confirmation Request

[*Sample Institution Letterhead*]

[*Name and address*] [*Date*]

In connection with their examination of our records, please confirm the correctness of the following information directly to our auditors, A.B. & Co., Certified Public Accountants, 100 Main Street, Any City, State, Zip Code.

Our records show that at the close of business on ________ [*date*] ________

(You were indebted to us)* for

(We were indebted to you)*

(You held for our account)*

(We held for your account)*

IF YOUR RECORDS AGREE WITH THE INFORMATION SHOWN, NO REPLY IS NECESSARY.

IF YOUR RECORDS DO NOT AGREE with the information shown, please indicate what you believe to be the correct information, sign in the space provided, and return this letter to our auditors in the enclosed self-addressed, stamped envelope.

Sincerely,

Sample Institution ____________________

By ________________________________

A.B. & Co.:
The above information is not correct. The differences are as follows:

____

____

____

Date ______________________ Signature ______________________

Title ______________________

* Line out the items that are not applicable.

Note to Recipient: This form may be used for transactions such as safekeeping, collection items, letters of credit, securities, federal funds, or security repurchase agreements.

General Purpose Positive Confirmation Request

[Sample Institution Letterhead]

[*Name and address*] [*Date*]

In connection with their examination of our records, please confirm the correctness of the following information directly to our auditors, A.B. & Co., Certified Public Accountants, 100 Main Street, Any City, State, Zip Code.

Our records show that at the close of business on ________ [*date*] ________

(You were indebted to us)* for

(We were indebted to you)*

(You held for our account)*

(We held for your account)*

IF YOUR RECORDS AGREE with the information shown, please sign in the appropriate space below and return this letter to our auditors in the enclosed self-addressed, stamped envelope.

IF YOUR RECORDS DO NOT AGREE with the information shown, please sign in the appropriate space below, indicate what you believe to be the correct information, and return this letter to our auditors.

Sincerely,

Sample Institution ____________________

By ________________________________

A.B. & Co.:
The above information is correct.

Date ____________________ Signature ______________________
Title ______________________

The above information is not correct. (The exceptions are shown on the reverse side of this letter.)

Date ____________________ Signature ______________________
Title ______________________

* Line out the items that are not applicable.

Note to Recipient: This form may be used for transactions such as safekeeping, collection items, letters of credit, securities, federal funds, or security repurchase agreements.

Appendix D

FDI Act Reporting Requirements

Section 36 of the Federal Deposit Insurance (FDI) Act requires reports by managements and independent accountants on financial statements, internal controls over financial reporting, and compliance with certain laws and regulations. (See chapter 2.) It also establishes minimum qualifications for independent accountants serving the affected institutions. The Section 36 provisions, as summarized below, apply to each Federal Deposit Insurance Corporation (FDIC)-insured depository institution having total assets of $500 million or greater at the beginning of its fiscal year. Despite the asset threshold, Section 36 does not override any non-FDI Act requirements for audited financial statements or other requirements that an institution exempt from Section 36 must otherwise satisfy.[1]

To implement Section 36, the FDIC issued both a final regulation[2] and accompanying guidelines and interpretations (guidelines), which became effective July 2, 1993. The general requirements are summarized below; however, the side-by-side analysis of the detailed regulation and guidelines presented in the exhibit that follows should be read.

Annual Report. Management is required to prepare, annually, a report that includes the following:[3]

- Financial statements prepared in conformity with generally accepted accounting principles (GAAP)
- A written assertion about the effectiveness at year-end of the institution's internal controls over financial reporting
- A written assertion about the institution's compliance during the year with (*a*) federal laws and regulations relative to insider loans, and (*b*) federal and state laws and regulations relative to dividend restrictions

Management must also include a statement about its responsibilities for the financial statements, financial reporting controls, and compliance with laws and regulations.

Management must engage an independent accountant to provide the following reports annually:

---

[1] In FDIC Financial Institution Letter (FIL) 43-93, the FDIC noted that, in adopting the final rule implementing Section 36, the Board of Directors of the FDIC reiterated its belief that "every depository institution, regardless of size or charter, should voluntarily have an annual audit of its financial statements by an independent public accountant and establish an independent audit committee."

[2] The regulation and guidelines implementing FDI Act Section 36 are codified in Title 12 of the Code of Federal Regulations (CFR) Part 363. The regulation was published in the *Federal Register* on June 2, 1993, and in FDIC FIL 41-93 and Office of the Comptroller of the Currency (OCC) Banking Bulletin (BB) 93-45. In January 1995, the FDIC proposed technical changes to required compliance attestation procedures and certain other changes (*Federal Register*, February 15, 1995). In that proposal, the FDIC refers managements and accountants to the May 1994 addendum to the Committee of Sponsoring Organizations of the Treadway Commission's (COSO's) September 1992 *Internal Control—Integrated Framework* for reporting guidance on internal controls involving safeguarding of assets. Readers should be alert to any final rule. Some of the related issues were first addressed in FDIC FIL 86-94.

[3] The reporting requirements may be satisfied for certain subsidiaries through reporting by their holding companies. These exemptions are discussed in Section 363.1 of the rule and in guidelines 2–4.

- An audit report on the GAAP-basis financial statements
- An examination-level attestation report on management's assertion about financial reporting controls

An agreed-upon procedures-level attestation report on management's assertion about compliance with insider loan and dividend restriction laws and regulations is also required, but is not included in the institution's annual report and, therefore, is not publicly available.

The financial statement audit is to be performed in accordance with generally accepted auditing standards (GAAS). The examination of management's assertion about financial reporting controls and the agreed-upon procedures report on management's compliance assertion are to be performed in accordance with the AICPA's Statements on Standards for Attestation Engagements (SSAE).

The audited financial statements and other reports of management and the independent accountant must be filed with the FDIC and other regulatory agencies within the ninety days following the institution's fiscal year-end. Management must also file any management letter, qualification, or other report within fifteen days following receipt from the independent accountant.

All of management's reports are made publicly available. The independent accountant's report on the financial statements and attestation report on financial reporting controls is also made publicly available. The independent accountant's agreed-upon procedures report and any management letter, while filed with the FDIC, and the appropriate federal banking agency (and any appropriate state bank supervisor) are not included in the annual report and, therefore, are not publicly available.

Qualifications of Independent Accountants. Acceptance of an engagement to report under Section 36 is conditioned on the independent accountant being enrolled in a practice-monitoring program. Membership in the AICPA Division for Firms' Securities and Exchange Commission (SEC) Practice Section or Private Companies Practice Section, or enrollment in the AICPA's Peer Review Program will satisfy this requirement.

Another condition of the engagement is that the independent accountant agree to provide regulators with access to workpapers related to the three engagement reports. Although this condition is not explicitly expressed in the law or regulations, the implementing guidelines also call for providing copies of workpapers to regulators. Independent accountants should be familiar with the Auditing Interpretation entitled "Providing Access to or Photocopies of Working Papers to a Regulator" (AICPA, *Professional Standards*, vol. 1, AU sec. 9339, "Working Papers").

The accountant must meet the independence requirements and interpretations of the AICPA and the SEC and its staff.

The implementing regulation requires both management and independent accountants to provide certain notifications of changes in an institution's independent accountants within specified time periods. An independent accountant must also file a peer review report within fifteen days of acceptance of the report.

Enforcement Actions Against Accountants. Section 36 of the FDI Act also provides for enforcement actions against accountants with respect to the Section 36 requirements. However, the regulatory agencies have not yet proposed or published rules or guidelines to implement this statutory requirement.[4]

Communication With Auditors. Each subject institution must provide its independent accountant with copies of the institution's most recent reports of condition and examination; any supervisory memorandum of understanding or written agreement with any federal or state regulatory agency; and a report of any action initiated or taken by federal or state banking regulators.

Audit Committees. Each subject institution must have an independent audit committee made up entirely of outside directors independent of management. One of the audit committee's required duties is to review with management and the independent accountant the reports required under Section 36. A list of other suggested duties is included in the guidelines, some of which relate to the independent accountant. Audit committees of institutions having $3 billion or more in assets must include members with banking or related financial management expertise, have access to their own outside counsel, and not include any large customers of the institution.

[4] Section 36(g)(4) of the FDI Act states that the FDIC or the appropriate federal banking agency may "remove, suspend, or bar an independent public accountant, upon a showing of good cause, from performing audit services" required by Section 36. The federal banking agencies are expected to jointly issue rules to implement this provision.

AUDIT AND REPORTING REQUIREMENTS

Reprinted below are Part 363 of Title 12 of the Code of Federal Regulations (12 CFR) Part 363 — Annual Independent Audits and Reporting Requirements (left column) and Appendix A to Part 363 — Guidelines and Interpretations (center column). The regulation and appendix were published in the June 2, 1993 *Federal Register*. The right column provides guidance for independent accountants on implementation of the regulation and guidelines.

Regulation	*Guidelines*	*Commentary*
§363.1 SCOPE		
(a) Applicability. This part applies with respect to fiscal years of insured depository institutions which begin after December 31, 1992. This part does not apply with respect to any fiscal year of any insured depository institution, the total assets of which, at the beginning of such fiscal year, are less than $500 million.	1. Measuring Total Assets. To determine whether this part applies, an institution should use total assets as reported on its most recent Report of Condition (Call Report) or Thrift Financial Report (TFR), the date of which coincides with the end of its preceding fiscal year. If its fiscal year ends on a date other than the end of a calendar quarter, it should use its Call Report or TFR for the quarter end immediately preceding the end of its fiscal year.	• The requirements for independent accountants apply only to accountants serving the subject institutions. If an institution does not fall within the scope of 12 CFR Part 363, neither the institution nor its independent accountant is subject to the rule or guidelines.
	2. Insured Branches of Foreign Banks. Unlike other institutions, insured branches of foreign banks are not separately incorporated or capitalized. To determine whether this part applies, an insured branch should measure claims on nonrelated parties reported on its Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (form FFIEC 002).	
(b) Compliance by subsidiaries of holding companies. The audited financial statements requirement of §363.2(a) may be satisfied for an insured depository institution that is a subsidiary of a holding	3. Compliance by Holding Company Subsidiaries. Audited consolidated financial statements and other reports or notices required by this part which are submitted by a holding company for any subsidiary institution, should be accompa-	

company by audited financial statements of the consolidated holding company. The other requirements of this part for an insured depository institution that is a subsidiary of a holding company may be satisfied by the holding company if:

(1) The services and functions comparable to those required of the insured depository institution by this part are provided at the holding company level; and

(2) Either the insured depository institution has total assets as of the beginning of such fiscal year of:

(i) less than $5 billion; or

(ii) more than $5 billion, but less than $9 billion, and a composite CAMEL (or MACRO, or equivalent) rating of 1 or 2.

nied by a cover letter identifying all subsidiary institutions to which they pertain. An institution filing holding company consolidated financial statements as permitted by §363.1(b) also may report on changes in its independent public accountant on a holding company basis. An institution that does not meet the criteria in section 36(i) must satisfy the remaining provisions of the statute and this part on an individual institution basis, and maintain its own audit committee. Multi-tiered holding companies may satisfy all requirements of this part at any level.

4. Comparable Services and Functions. Services and functions will be considered "comparable" to those required by this part if the holding company:

   (a) Prepares reports used by the subsidiary institution to meet the requirements of this part;

   (b) Has an audit committee that meets the requirements of the part appropriate to its largest subsidiary institution; and

   (c) Prepares and submits the management assessments of the effectiveness of the internal control structure and procedures for financial reporting ("internal controls"), and compliance with the Designated Laws defined in

- The guidelines use *internal controls* throughout to refer to internal controls over financial reporting. Management and independent accountant reports required by the rule relate only to financial reporting controls — including *safeguarding of assets* as discussed in guideline 9. These controls do *not* extend to compliance with applicable federal, state, and local laws and regulations (*compliance controls*) or controls over effectiveness and efficiency of operations (*operational controls*).

- Guideline 4(c) permits management to make an assertion about the financial reporting controls of more than one of its subsidiary institutions within the scope of 12 CFR Part 363 (a covered subsidiary). However, the au-

(Continued)

Regulation	*Guidelines*	*Commentary*
	Guideline 12 that are based on information concerning the activities and operations of all subsidiary institutions within the scope of this part.	ditor's report should relate to an assertion about the financial reporting controls of either (1) a holding company and all subsidiary institutions, or (2) a covered subsidiary. That is, the auditor's report should not relate to combined assertions of more than one covered subsidiary unless both subsidiaries are part of a consolidated group and the auditor is reporting on the holding company and all subsidiaries (both covered and not covered). • In applying guideline 4(c) to performance of the compliance attestation procedures, if the independent accountant performs procedures listed in Section I below, he or she could use sample sizes calculated on a consolidated basis for the holding company and all covered subsidiaries of that holding company. Sample sizes for covered subsidiaries that are not being reported on following guideline 4(c) should not be calculated on a consolidated basis.
§363.2 ANNUAL REPORTING REQUIREMENTS *(a) Audited financial statements. Each insured depository institution shall prepare annual financial statements in accordance with generally accepted account-*	5. Annual Financial Statements. Each institution should prepare comparative annual consolidated financial statements (balance sheets, statements of income, changes in equity capital,	

ing principles which shall be audited by an independent public accountant.	and cash flows, with accompanying footnote disclosures) in accordance with generally accepted accounting principles (GAAP) for each of its two most recent fiscal years. Statements for the earlier year may be presented on an unaudited basis if the institution was not subject to this part for that year and audited statements were not prepared. 6. <u>Holding Company Statements</u>. Subsidiary institutions may file copies of their holding company's audited financial statements filed with the Securities and Exchange Commission (SEC) or prepared for their FR Y-6 Annual Report under the Bank Holding Company Act of 1956. 7. <u>Insured Branches of Foreign Banks</u>. An insured branch of a foreign bank should satisfy the financial statements requirement by filing one of the following for the two preceding fiscal years: (a) Audited balance sheets, disclosing information about financial instruments with off-balance-sheet risk; (b) Schedules RAL and L of form FFIEC 002, prepared and audited on the basis of the instructions for its preparation; or (c) With written approval of the appropriate federal banking agency, consolidated financial statements of the parent bank.	• The guidelines permit insured branches of foreign banks to satisfy the requirement with (a) a balance sheet prepared in conformity with United States GAAP; (b) a schedule prepared on another comprehensive basis of accounting defined in the Federal Financial Institutions Examination Council (FFIEC) Consolidated Reports of Condition and Income (Call Reports) or Thrift Financial Reports (TFRs) instructions; or (c) the parent bank's consolidated financial statements, which may be prepared on a basis other than United States generally accepted accounting principles (GAAP).

(Continued)

Regulation	Guidelines	Commentary
(b) <u>Management report.</u> Each insured <u>depository institution</u> annually shall prepare, as of the end of the institution's most recent fiscal year, a management report signed by its chief executive officer and chief accounting or chief financial officer which contains: *(1) A statement of management's responsibilities for preparing the institution's annual financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with laws and regulations relating to safety and soundness which are designated by the FDIC and the appropriate federal banking agency; and*	8. <u>Management Report.</u> Management should perform its own investigation and review of the effectiveness of internal controls and compliance with Designated Laws defined in guideline 12. Management also should maintain records of its determinations and assessments until the next federal safety and soundness examination, or such later date as specified by the FDIC or appropriate federal banking agency. Management should provide in its assessment of the effectiveness of internal controls and compliance with the Designated Laws, or supplementally, sufficient information to enable the accountant to report on its assertions. The management report of an insured branch of a foreign bank should be signed by the branch's managing official if the branch does not have a chief executive or financial officer.	• Statement on Standards for Attestation Engagements (SSAE) No. 2, *Reporting on an Entity's Internal Control Structure Over Financial Reporting* (AICPA, *Professional Standards*, vol. 1, AT sec. 400), states "an entity's internal control structure over financial reporting includes those policies and procedures that pertain to an entity's ability to record, process, summarize, and report financial data consistent with the assertions embodied in either annual financial statements or interim financial statements, or both" (paragraph 2).* Accordingly, management's assertion and the independent accountant's report should relate to the assertions embodied in the annual financial statements required by 12 CFR §363.2(a). The FDIC, FRB, and the OCC have stated that management's assertion is expected to address call reporting. See commentary on guideline 10.

* In December 1995, the Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). SAS No. 78 revises the definition and description of internal control contained in the SASs to recognize the definition and description contained in *Internal Control—Integrated Framework* published by the Committee of Sponsoring Organizations of the Treadway Commission. SAS No. 78 is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted.

In conjunction with SAS No. 78, the ASB issued Statement on Standards for Attestation Engagements (SSAE) No. 6, *Reporting on an Entity's Internal Control Over Financial Reporting: An Amendment to Statement on Standards for Attestation Engagements No. 2* (AICPA, *Professional Standards*, vol. 1, AT sec. 400). SSAE No. 6 conforms the description of elements of an entity's internal control to the components of internal control contained in SAS No. 78 and the *Internal Control—Integrated Framework*. SSAE No. 6 is effective for an examination of management's assertion when the assertion is as of or for the period ending on December 15, 1996, or thereafter, with earlier application permitted.

(2) Assessments by management of the effectiveness of such internal control structure and procedures as of the end of such fiscal year and the institution's compliance with such laws and regulations during such fiscal year.

9. Safeguarding of Assets. The FDIC believes "safeguarding of assets," as the term relates to internal controls policies and procedures regarding financial reporting, and which has precedent in accounting literature, should be addressed in the management report and the independent public accountant's attestation discussed in guideline 18. It also believes that testing the existence of and compliance with internal controls on the management of assets, including loan underwriting and documentation, represents a reasonable implementation of section 36. Management should therefore address such internal controls as part of its management report, and the accountant should test compliance with them. Recognizing the lack of objective criteria against which the accountant may judge safeguarding of assets, however, the FDIC does not require the accountant to

- Guideline 8 supports the concept in SSAE No. 3, *Compliance Attestation*, that management's assertion be specific enough to be capable of evaluation.

- SSAE No. 2 addresses "safeguarding of assets" as required by guideline 9.[1] Management's assertion about, and the independent accountant's tests of, financial reporting controls will consider "safeguarding of assets" policies and procedures accordingly. The independent accountant's tests of controls over financial reporting of loans, for example, should include tests of whether the institution is executing transactions in accordance with management's policies for loan underwriting and loan documentation. Such procedures might include, for example, comparing approvals for loan transactions to management's written policy to ascertain whether the loan was approved by an officer or committee consistent with the authority limits specified for that officer or committee in the policy.

[1] Specifically, paragraph 27 of SSAE No. 2 states:

> In the context of an entity's internal control structure, safeguarding of assets refers only to protection against loss from errors and irregularities in the processing of transactions and the handling of related assets. It does not include, for example, loss of assets arising from management's operating decisions, such as selling a product that proves to be unprofitable, incurring expenditures for equipment or material that proves to be unnecessary or unsatisfactory, authorizing what proves to be unproductive research or ineffective advertising, or accepting some level of merchandise pilferage by customers as part of operating a retail business.

See also Appendix D of SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).

(Continued)

Regulation	Guidelines	Commentary
	attest to the adequacy of safeguards, but only to determine whether safeguarding policies exist, and whether management has implemented them.[2]	The Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued a report, *Internal Control—Integrated Framework,* in September 1992 (see commentary on guideline 10). In May 1994, COSO issued a document titled *Addendum to "Reporting to External Parties."* The Addendum to the COSO report encourages managements that report to external parties on controls over financial reporting to also cover controls over safeguarding of assets against unauthorized acquisition, use, or disposition. It also encourages managements to include specific reference to those controls in the report. As noted in the Addendum, controls over the safeguarding of assets against unauthorized acquisition, use, or disposition may fall either in the category of financial reporting controls (if they are needed to ensure reliable financial reporting), in the category of operating controls, or both. *Bank Reporting.* Accountants are likely to encounter three kinds of management assertions: 1. Some institutions may make assertions about financial reporting controls, including safeguarding controls.

2 It is management's responsibility to establish underwriting policies and to make credit decisions. The auditor's role is to test compliance with management's policies.

2. Some institutions may make assertions about financial reporting controls and safeguarding controls.

3. Some institutions may choose not to refer to safeguarding controls.

Accountant Attestation. In all cases, the scope of the accountant's work should include those internal controls over the safeguarding of assets against unauthorized acquisition, use, or disposition of assets that are part of the financial reporing controls (that is, those safeguarding controls that are needed to ensure reliable financial reporting). The wording of the auditor's attestation report will vary, depending on the scope and wording of management's report, as discussed below:

- When management's assertion makes specific reference to safeguarding controls using language such as "... controls over financial reporting, *including* controls over the safeguarding of *assets* ... the accountant's reports should parallel management's assertion. The scope of the accountant's work is unaffected *since* all controls included in the management's assertions are, in essence, financial reporting controls.

(Continued)

Regulation	Guidelines	Commentary
		● When management's assertion is silent on safeguarding controls, the accountant's report, and the *scope of* his or her work, is unaffected. ● If management's assertion makes reference to safeguarding controls using language such as ". . . controls over financial reporting, and controls over the safeguarding . . . ," the accountant should carefully consider whether the controls covered by the assertion fall outside the financial reporting controls category, and whether the wording adequately communicates the *scope of* the assertion. In such cases, the accountant should do one of the following: 1. Ask management to consider changing its assertion to use the wording "controls over financial reporting, *including controls* over the safeguarding of *assets* . . . . " 2. Ask management *to* clarify its definition of those safeguarding controls included in its assertion (which would also have to be included in the scope of the accountant's work) and state the criteria used to assess the adequacy of those controls if the accountant believes the wording of management's assertion does not adequately communicate its scope.

10. Standards for Internal Controls. Each institution should determine its own standards for establishing, maintaining and assessing the effectiveness of its internal controls.[3]

3. Disclaim an opinion on that portion of management's assertion which was not included within the scope of the accountant's work.

- SSAE No. 2 establishes conditions for the acceptance of engagements to examine and attest to management assertions about financial reporting controls. One condition is that management evaluate the effectiveness of the institution's financial reporting controls using reasonable criteria for effective internal control structures established by a recognized body. Criteria issued by the AICPA, regulatory agencies, or other bodies that comprise experts who follow due process procedures, including procedures for the broad distribution of proposed criteria for public comment, usually should be considered reasonable criteria for this purpose. For example, the report *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission provides reasonable criteria.

[3] In considering what information is needed on safeguarding of assets and standards for internal controls, management may review guidelines provided by its primary federal regulator; the Federal Financial Institutions Examination Council's "Supervisory Policy Statement on Securities Activities"; the FDIC's "Statement of Policy Providing Guidance on External Auditing Procedures for State Nonmember Banks" (Jan. 16, 1990), "Statement of Policy Regarding Independent External Auditing Programs of State Nonmember Banks" (Nov. 16, 1988), and Division of Supervision Manual of Examination Policies; the Federal Reserve Board's Commercial Bank Examination Manual and other relevant regulations; the Office of Thrift Supervision's Thrift Activities Handbook; the Comptroller of the Currency's Handbook for National Bank Examiners; standards published by professional accounting organizations, such as the American Institute of Certified Public Accountant's (AICPA) Statement on Auditing Standards No. 30, "Reporting on Internal Accounting Control"; and other internal control standards published by the AICPA, other accounting or auditing professional associations, and financial institution trade associations.

(Continued)

Regulation	*Guidelines*	*Commentary*
		The Auditing Standards Board has a project under way to conform SAS No. 55 to the COSO report. SAS No. 30, *Reporting on Internal Accounting Control,* has been superseded by SSAE No. 2. • Section 36 requires management to include in its annual report a written assertion about the effectiveness of the institution's internal control structure over financial reporting as of the end of the institution's fiscal year. Final implementing regulations and guidelines for Section 36 offer no guidance about whether management should consider Call Reports or TFRs for the purposes of reporting under Section 36. When developed, SSAE No. 2 did not contemplate inclusion of controls over call reporting as part of the internal control structure over financial reporting. Some institutions have held that considering Call Reports or TFRs within the scope of management's assertion (and the related independent accountant's attestation) will be burdensome and costly. However, the staffs of the FDIC, FRB, and the OCC have stated that management's assertion is expected to consider Call Reports or TFRs within the scope of financial reporting controls addressed by management's assertion. *Management assertions*. Because of the differing views (discussed above) over the inclusion of call reporting, it is preferable that management's report specify the scope of finan-

cial reporting about which management is making its assertions.

Example A — Management report in which scope is financial reporting in conformity with GAAP and Call Report (or TFR) instructions:

Internal Control Structure Over Financial Reporting

Management is responsible for establishing and maintaining an effective internal control structure over financial reporting presented in conformity with both generally accepted accounting principles and the Federal Financial Institutions Examination Council instructions for Consolidated Reports of Condition and Income (call report instructions) [or, *Office of Thrift Supervision Instructions for Thrift Financial Reports (TFR instructions)*]. The structure contains monitoring mechanisms, and actions are taken to correct deficiencies identified.

There are inherent limitations in the effectiveness of any structure of internal control, including the possibility of human error and the circumvention or overriding of controls. Accordingly, even an effective internal control structure can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of an internal control structure may vary over time.

(Continued)

Regulation	*Guidelines*	*Commentary*
		Management assessed the institution's internal control structure over financial reporting presented in conformity with both generally accepted accounting principles and call report [or *TFR*] instructions as of December 31, 19XX. This assessment was based on criteria for effective internal control over financial reporting described in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management believes that, as of December 31, 19XX, XYZ National Bank maintained an effective internal control structure over financial reporting presented in conformity with both generally accepted accounting principles and call report [or *TFR*] instructions. *Example B — Management report in which scope is financial reporting in conformity with GAAP:* **Internal Control Structure Over Financial Reporting** Management is responsible for establishing and maintaining an effective internal control structure over financial reporting presented

in conformity with generally accepted accounting principles. The structure contains monitoring mechanisms, and actions are taken to correct deficiencies identified.

There are inherent limitations in the effectiveness of any structure of internal control, including the possibility of human error and the circumvention or overriding of controls. Accordingly, even an effective internal control structure can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of an internal control structure may vary over time.

Management assessed the institution's internal control structure over financial reporting presented in conformity with generally accepted accounting principles as of December 31, 19XX. This assessment was based on criteria for effective internal control over financial reporting described in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management believes that, as of December 31, 19XX, XYZ National Bank maintained an effective internal control structure over financial report-

(Continued)

Regulation	Guidelines	Commentary
		ing presented in conformity with generally accepted accounting principles.
		Attestation reports. The FDICIA requires that, with respect to any internal control report required of management, the independent accountant shall attest to and report on management's assertions contained in the report.
		Standard independent accountant's report. Following is an illustrative independent accountant's report (following SSAE No. 2) for use with either of the management assertions presented as examples A and B above.
		Independent Accountant's Report
		[*Introductory paragraph*]
		We have examined management's assertion [*describe management's assertion as in example A or B*] as of December 31, 19XX, included in the accompanying [*title of management report*].
		[*Scope paragraph*]
		Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an un-

derstanding of the internal control structure over financial reporting, testing, and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[*Inherent limitations paragraph*]

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, management's assertion [*describe management's assertion as in example A or B*] as of December 31, 19XX, is fairly stated, in all material respects, based on *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

(Continued)

Regulation	*Guidelines*	*Commentary*
		If management's assertion does not specify the scope of financial reporting about which management is making its assertion, the independent accountant should ascertain the scope of management's assertion and discuss with management the preferability of its assertion being explicit as to scope. If management's assertion is not explicit, the accountant's attestation report should describe the scope of management's assertion according to the following example:

Independent Accountant's Report

[Introductory paragraph]

We have examined management's assertion that XYZ National Bank maintained an effective internal control structure over financial reporting. Management has informed us that the scope of their assertion includes financial reporting presented in conformity with [*both*] generally accepted accounting principles [*and the Federal Financial Institutions Examination Council Instructions for Consolidated Reports of Condition and Income; and Office of Thrift Supervision Instructions for Thrift Financial Reports*].

[Standard scope and inherent limitations paragraphs]

[Opinion paragraph]

In our opinion, management's assertion that XYZ National Bank maintained an effective internal control structure over financial reporting as of December 31, 19XX (as described above) is fairly stated, in all material respects, based on *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Reports on limited engagements. In certain cases, management might issue a report similar to that in Example A above (the scope of which includes financial reporting presented in conformity with both GAAP and Call Report or TFR instructions) but might engage the independent accountant only to attest to the assertion as it relates to financial reporting in conformity with GAAP. In such cases, the independent accountant's report should address the limited reporting objective and disclaim an opinion on that portion of management's assertion about the institution's internal control structure over financial reporting presented in conformity with Call Report or TFR instructions.

(Continued)

Regulation	*Guidelines*	*Commentary*
		Following is an example of an explanatory paragraph that should be included in a report issued in these circumstances (or in similar circumstances where management's assertion is not explicit as to its scope):

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion (included in the accompanying [*title of management report*] that, as of December 31, 19XX, XYZ National Bank maintained an effective internal control structure over financial reporting presented in conformity with generally accepted accounting principles.

[*Standard scope and inherent limitations paragraphs*]

[*Explanatory paragraph*]

We were not engaged to examine management's assertion as it relates to the internal control structure over financial reporting presented in conformity with the Federal Financial Institutions Examination Council Instructions for Consolidated Reports of Condition and Income [or *Office of Thrift Supervision Instructions for Thrift Financial Reports*]. Accordingly, we do not express an opinion on that assertion.

[Opinion paragraph]

In our opinion, management's assertion that, as of December 31, 19XX, XYZ National Bank maintained an effective internal control structure over financial reporting presented in conformity with generally accepted accounting principles is fairly stated, in all material respects, based on *Internal Control —Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

11. Service Organizations. Although service organizations should be considered in determining if internal controls are adequate, an institution's independent public accountant, its management, and its audit committee should exercise independent judgment concerning that determination. On-site reviews of service organizations may not be necessary to prepare the reports required by the Rule, and the FDIC does not intend that the Rule establish any such requirement.

- SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), which provides guidance to independent accountants of a service organization on issuing a report on certain aspects of the service organization's internal control structure that can be used by other independent accountants, also provides guidance on how other independent accountants should use such reports. Further, paragraphs 84 through 87 of SSAE No. 2 discuss the relationship of the practitioner's examination of an entity's internal control structure to the opinion obtained in an audit of financial statements.

(Continued)

Regulation	Guidelines	Commentary
	12. Compliance With Laws and Regulations. The designated laws and regulations are the federal laws and regulations concerning loans to insiders and the federal and state laws and regulations concerning dividend restrictions, which are more specifically identified in Section I of the Agreed Upon Procedures referred to in guideline 19 (the Designated Laws).	
§363.3 INDEPENDENT PUBLIC ACCOUNTANT *(a) Annual audit of financial statements. Each insured depository institution shall engage an independent public accountant to audit and report on its annual financial statements in accordance with generally accepted auditing standards and section 37 of the Federal Deposit Insurance Act (12 U.S.C. 1831n). The scope of the audit engagement shall be sufficient to permit such accountant to determine and report whether the financial statements are presented fairly and in accordance with generally accepted accounting principles.*	13. General Qualifications. To provide audit and attest services to insured depository institutions, an independent public accountant should be registered or licensed to practice as a public accountant, and be in good standing, under the laws of the state or other political subdivision of the United States in which the home office of the institution (or the insured branch of a foreign bank) is located. As required by section 36(g)(3)(A)(i), the accountant must agree to provide copies of any workpapers, policies, and procedures relating to services performed under this part.	• If the independent public accountant is a firm, the firm and the signing partner should meet the qualification criteria. • Practitioners should be familiar with the Auditing Interpretation entitled "Providing Access to or Photocopies of Working Papers to a Regulator" (AICPA, *Professional Standards*, vol. 1, sec. 9339, "Working Papers").

14. Independence. The independent public accountant also should be in compliance with the AICPA's *Code of Professional Conduct* and meet the independence requirements and interpretations of the SEC and its staff.

15. Peer Reviews. As required by section 36(g)(3)(A)(ii), the independent public accountant must have received, or be enrolled in, a peer review that meets acceptable guidelines. The following peer review guidelines are acceptable:

   (a) The external peer review should be conducted by an organization independent of the accountant or firm being reviewed, as frequently as is consistent with professional accounting practices;

   (b) The peer review should be generally consistent with AICPA standards;[4] and

   (c) The review should include, if available, at least one audit of an insured depository institution

- Under guideline 14, independent accountants not currently subject to the Securities and Exchange Commission's (SEC's) independence requirements must meet those requirements.

- Guideline 15 acknowledges that certain firms — for example, those that have been recently formed — may be enrolled in a practice monitoring program but may not have yet received a review. It also recognizes that certain firms may not have previously performed audits of depository institution financial statements.

- Current practice, as referred to by guideline 15(a), requires a review once every three years.

- Guidance on making workpapers available to the FDIC in a form consistent with the SEC's agreement, as referred to by guideline 15(c), is available from the AICPA's Peer Re-

[4] These would include Standards for Performing and Reporting on Peer Reviews, codified in the SEC *Practice Section Reference Manual*; Standards for Performing and Reporting on Peer Reviews, contained in Volume 2 of the AICPA's *Professional Standards*; or Standards for Performing and Reporting on Peer Reviews, of the AICPA's Private Companies Practice Section.

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Regulation	Guidelines	Commentary
	or consolidated financial holding company. Peer review working papers are to be retained for 120 days after the peer review report is filed with the FDIC, and be made available to the FDIC upon request, in a form consistent with the SEC's agreement with the accounting profession.	view Division to independent accountants who receive such a request from the FDIC. • Based on footnote 3 to guideline 15, membership in the AICPA's Division for CPA Firms' SEC Practice Section or Private Companies Practice Section or enrollment in the AICPA Quality Review Program should satisfy the requirement.
	16. Filing Peer Review Reports. Within 15 days of receiving notification that the peer review has been accepted, or before commencing any audit under this part, whichever is earlier, two copies of the peer review report, accompanied by any letter of comments and letter of response, should be filed by the independent public accountant with the FDIC, Registration and Disclosure Section, 550 17th Street, NW, Washington, DC 20429, where they will be available for public inspection. Accountants may elect to file an annual list of their insured depository institution and holding company (identifying any subsidiary institutions subject to this part) audit clients in lieu of copies of peer review reports for each institution they have been engaged to audit. The FDIC has determined that such client lists are exempt from public disclosure. All corrective action required under any qualified peer review report should have been taken prior to commencing services under this part.	• Consistent with guideline 15, a firm that is enrolled in a practice monitoring program, but has not yet received a report, would not be required to file a report before commencing an engagement under the rule.

(b) Additional reports. Such independent public accountant shall examine, attest to, and report separately on, the assertions of management concerning the institution's internal control structure and procedures for financial reporting. The accountant shall apply procedures agreed upon by the FDIC objectively to determine compliance by an insured de-

17. Information to Independent Public Accountant. Attention is directed to section 36(h) which requires institutions to provide specified information to their accountants. An institution also should provide its accountant with copies of any notice that the institution's capital category is being changed or reclassified under section 38 of the FDI Act, and any correspondence from the appropriate federal banking agency concerning compliance with this part.

18. Attestation Reports. The independent public accountant should provide the institution with an internal controls attestation report, a compliance with Designated Laws attestation report, and any management letter, at the conclusion of the audit as required by section 36(c)(1). If a holding company subsidiary relies on its holding company management report, the accountant may attest to and report on the management's

- Section 36(h) referred to by guideline 17 requires an institution to generally provide its independent accountant with copies of the following:
  - — The institution's most recent Call Report (or TFR) and report of examination
  - — Any supervisory memorandum of understanding and any written agreement between the institution and any federal or state banking agency
  - — A report of any action initiated or taken by federal or state banking agencies
  - — A report of any assessment of any civil money penalty under any other provision of law with respect to the institution or any institution-affiliated party.
- Practitioners should consult SSAEs No. 2 and No. 3 for guidance on reporting that involves multiple locations.
- The independent accountant's compliance attestation report and any management letter will not be publicly available.

(Continued)

Regulation	Guidelines	Commentary
pository institution with designated laws and regulations. The attestations shall be made in accordance with generally accepted standards for attestation engagements.	assertions in one report, without reporting separately on each subsidiary covered by this part. One attestation report for compliance with the Designated Laws also may be filed, if all exceptions are listed and the respective institutions to which the exceptions apply are identified. The FDIC has determined that management letters and the Designated Laws attestation report are exempt from public disclosure.	
	19. Procedures for Determining Compliance with Designated Laws. In order to permit the independent public accountant to determine the extent of compliance with the Designated Laws defined in guideline 12 and the related assessment by management, the procedures set forth in schedule A (the Agreed Upon Procedures) to these Guidelines should be applied. The accountant should require all management representations to be in writing, and take appropriate steps to determine that any sampling is reasonably representative. Attestation reports generally should identify all findings from application of the Agreed Upon Procedures which establish any items of non-compliance, note any absence of written policies, and disclose the reasons why any Agreed Upon Procedures were not performed.	• Although guideline 19 refers to a determination about compliance with laws and regulations, the independent accountant will make no such determination. Rather, the independent accountant will report procedures performed and findings. The FDIC and other regulatory agencies will have to consider the procedures and findings in making their own determination about compliance. • The AICPA's SSAEs provide guidance on reporting findings, and scope limitations.
	20. Reviews with Audit Committee and Management. The independent public accountant should meet with the institution's audit committee to review the accountant's reports required by this part before they are filed. It also	

(c) Notice by accountant of termination of services. An independent public accountant performing an audit under this part who ceases to be the accountant for an insured depository institution shall notify the FDIC and the appropriate federal banking agency in writing of such termination within 15 days after the occurrence of such event, and set forth in reasonable detail the reasons for such termination.

may be appropriate for the accountant to review its findings with the institution's board of directors and management.

21. Notice of Termination. The notice required by §363.3(c) should state whether the independent accountant agrees with the assertions contained in any notice filed by the institution under §363.4(d), and whether the institution's notice discloses all relevant reasons.

22. Reliance on Internal Auditors. Nothing in this part or this appendix is intended to preclude the ability of the independent public accountant to rely on the work of an institution's internal auditor.

- The extent to which the independent accountant may consider the work of internal auditors in a financial statement audit is addressed in SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322). SSAE No. 2 refers the accountant to SAS No. 65 when addressing the competence and objectivity of internal auditors; the nature, timing, and extent of work to be performed; and other related matters in an examination-level attestation engagement (such as a report on the examination of management's assertion about financial reporting controls). SAS No. 65 was not written to apply to the agreed-upon procedures engagements. The Auditing Standards Board is addressing internal au-

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Regulation	Guidelines	Commentary
		ditors' participation in agreed-upon procedures engagements as part of a separate project on the overall concept of such engagements. The board has, however, concluded that a practitioner may not use internal auditors for direct assistance in an agreed-upon procedures engagement to satisfy the requirement in the FDI Act that an independent accountant perform agreed-upon procedures to test a financial institution's compliance with designated laws and regulations relating to safety and soundness.
§363.4 FILING AND NOTICE REQUIREMENTS *(a) Annual reporting. Within 90 days after the end of its fiscal year, each insured depository institution shall file with each of the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor, two copies of:* *(1) An annual report containing audited annual financial statements, the independent public accountant's report thereon, management's statements and assessments, and the independent public accountant's attestation report concerning the institution's internal control structure and procedures for financial reporting as required by §§363.2(a) and 363.3(a), 363.2(b), and 363.3(b) respectively; and*	23. Place for Filing. Except for peer review reports filed pursuant to Guideline 16, all reports and notices required by, and other communications or requests made pursuant to, this part should be filed as follows: (a) FDIC: Regional Director (Supervision) of the FDIC Regional Office in which the institution is headquartered; (b) Office of the Comptroller of the Currency (OCC): appropriate OCC Supervisory Office; (c) Federal Reserve: appropriate Federal Reserve Bank; (d) Office of Thrift Supervision (OTS): appropriate OTS District Office; and	

(2) the accountant's attestation concerning compliance with laws and regulations pursuant to §363.3(b).

(b) Public availability. The foregoing annual report in paragraph (a) of this section shall be available for public inspection.

(e) State bank supervisor: the filing office of the appropriate state bank supervisor.

24. Relief from Filing Deadlines. Although the FDIC believes that the deadlines for filings and other notices established by section 36 and this part are reasonable, it recognizes some institutions occasionally may be confronted with extraordinary circumstances beyond their reasonable control that may justify extensions of a deadline. In that event, upon written application from an insured depository institution, setting forth the reasons for any requested extension, the FDIC or appropriate federal banking agency may, for good cause shown, extend the deadline for a period not to exceed 30 days.

25. Public Availability. Each institution's annual report should be available for public inspection at its main and branch offices no later than 15 days after it is filed with the FDIC. Alternatively, an institution may elect to mail one copy of its annual report to any person who requests it. The annual report should remain available to the public until the annual report for the next year is available. An institution may use its annual report under this part to meet the annual disclosure statement required by 12 CFR 350.3, if the institution satisfies all other requirements of 12 CFR part 350.

- The publicly available annual report contains the independent accountant's audit report on financial statements and attestation report on management's assertion about financial reporting controls. The independent accountant's agreed-upon procedures report is not to be included in the annual report and is not publicly available.

(Continued)

Regulation	Guidelines	Commentary
(c) *Independent accountant's reports. Each insured depository institution shall file with the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor, a copy of any management letter, qualification, or other report issued by its independent public accountant with respect to such institution and the services provided by such accountant pursuant to this part within 15 days after receipt.*	26. Independent Public Accountant's Report. Section 36(h)(2)(A) requires that, within 15 days of receipt by an institution of any management letter or other report, such letter or other report shall be filed with the FDIC, any appropriate federal banking agency and any appropriate state bank supervisor. Institutions and their accountants are encouraged to coordinate preparation and delivery of audit and attestation reports and filing the annual report, to avoid duplicate filings.	• Note that management must file, within 15 days of receipt, reports of the independent accountant, even if they will be filed later with the annual report discussed in guidelines 23 and 25. For example, if management receives a letter communicating internal control structure matters noted in the interim fieldwork for a subject financial statement audit, that report should be filed when received. SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 530, *Dating of the Independent Auditor's Report*), provides guidance on dating of the independent auditor's report on financial statements. When providing final reports, practitioners may wish to include a transmittal letter, which will help document when the report was sent to the institution. • The law, implementing regulations, and guidelines do not eliminate the independent accountant's responsibility under generally accepted auditing standards (GAAS) for communicating internal control structure related matters noted in a financial statement audit. • "Other report" refers to the reports required by 12 CFR §363.
(d) *Notice of engagement or change of accountants. Each insured depository institution shall provide, within 15 days*	27. Notices Concerning Accountants. Institutions should review and satisfy themselves as to compliance with the required qualifications set forth	• The current report filed with regulators (that is, Form F-3 for the FDIC and SEC Form 8-K for others) includes the independent accoun-

after the occurrence of any such event, written notice to the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor of the engagement of an independent public accountant, or the resignation or dismissal of the independent public accountant previously engaged. The notice shall include a statement of the reasons for any such event in reasonable detail.

in guidelines 13-15 before engaging an independent public accountant. With respect to any selection, change or termination of an accountant, institutions should be familiar with the notice requirements in guideline 21, and should send a copy of any notice under §363.4(d) to the accountant when it is filed with the FDIC. An institution which files reports with its appropriate federal banking agency under, or is a subsidiary of a holding company which files reports with the SEC pursuant to, the Securities Exchange Act of 1934 may use its current report (*e.g.*, SEC Form 8-K) concerning a change in accountant to satisfy the similar notice requirements of this part.

tant's response to management's disclosures. However, it may not include all matters required to be reported under 12 CFR §363.3(c) and guideline 21.

§363.5 AUDIT COMMITTEES

(a) Composition and duties. Each insured depository institution shall establish an independent audit committee of its board of directors, the members of which shall be outside directors who are independent of management of the institution, and the duties of which shall include reviewing with management and the independent public accountant the basis for the reports issued under this part.

28. Composition. The board of directors of each institution should determine if outside directors meet the requirements of section 36 and this part. At least annually, it should determine whether all existing and potential audit committee members are "independent of management of the institution." If the institution has total assets in excess of $3 billion, the board also should determine whether members of the committee satisfy the additional requirements of this part. Because an insured branch of a foreign bank does not have a separate board of directors, the FDIC will not apply the audit committee requirements

(Continued)

Regulation	Guidelines	Commentary
	to such branch. However, any such branch is encouraged to make a reasonable good faith effort to see that similar duties are performed by persons whose experience is generally consistent with the Rule's requirements for an institution the size of the insured branch.	
	29. "Independent of Management" Considerations. In determining whether an outside director is independent of management, the board should consider all relevant information. This would include considering whether the director:	
	(a) Is or has been an officer or employee of the institution or its affiliates;	
	(b) Serves or served as a consultant, advisor, promoter, underwriter, legal counsel, or trustee of or to the institution or its affiliates;	
	(c) Is a relative of an officer or other employee of the institution or its affiliates;	
	(d) Holds or controls a direct or indirect financial interest in the institution or its affiliates; and	
	(e) Has outstanding extension of credit from the institution or its affiliates.	
	30. Lack of Independence. An outside director should not be considered independent of management if such director is, or has been within	

the preceding year, an officer or employee of the institution or any affiliate, or owns or controls, or has owned or controlled within the preceding year, assets representing 10 percent or more of any outstanding class of voting securities of the institution.

31. Holding Company Audit Committees. Members of an independent audit committee of a holding company may serve as the audit committee of any subsidiary institution if they are otherwise independent of management of the subsidiary. This would not, however, permit officers or employees of the holding company to serve on the audit committee of its subsidiary institutions. The audit committee of the holding company may perform all the duties of the audit committee of a subsidiary institution, even though such holding company directors are not directors of the institution.

32. Duties. The audit committee should perform all duties determined by the institution's board of directors. The duties should be appropriate to the size of the institution and the complexity of its operations, and include reviewing with management and the independent public accountant the basis for the reports issued under §363.2(b). Appropriate additional duties could include:

(a) Reviewing with management and the independent public accountant the scope of services required by the audit, significant account-

Regulation	*Guidelines*	*Commentary*
	ing policies, and audit conclusions regarding significant accounting estimates; (b) Reviewing with management and the accountant their assessments of the adequacy of internal controls, and the resolution of identified material weaknesses and reportable conditions in internal controls, including the prevention or detection of management override or compromise of the internal control system; (c) Reviewing with management and the accountant the institution's compliance with laws and regulations; (d) Discussing with management the selection and termination of the accountant and any significant disagreements between the accountant and management; and (e) Overseeing the internal audit function. It is recommended that audit committees maintain minutes and other relevant records of their meetings and decisions.	
(b) Committees of large institutions. The audit committee of any insured depository institution that has total assets of more than $3 billion, measured as of the beginning of each fiscal year, shall include members with banking or related financial management expertise, have access to its own outside counsel, and	33. Banking or Related Financial Management Expertise. At least two members of the audit committee of a large institution shall have "banking or related financial management expertise" as required by section 36(g)(1)(C)(i). This determination is to be made by the board of directors of the insured depository institution. A person will be considered to have such re-	

not include any large customers of the institution.	quired expertise if the person has significant executive, professional, educational, or regulatory experience in financial, auditing, accounting, or banking matters as determined by the board of directors. Significant experience as an officer or member of the board of directors or audit committee of a financial services company would satisfy these criteria. 34. Large Customers. Any individual or entity (including a controlling person of any such entity) which, in the determination of the board of directors, has such significant direct or indirect credit or other relationships with the institution, the termination of which likely would materially and adversely affect the institution's financial condition or results of operations, should be considered a "large customer" for purposes of §363.5(b). 35. Access to Counsel. The audit committee should be able to retain counsel at its discretion without prior permission of the institution's board of directors or its management. Section 36 does not preclude advice from the institution's internal counsel or regular outside counsel. It also does not require retaining or consulting counsel, but if the committee elects to do either, it also may elect to consider issues affecting the counsel's independence. Such issues would include whether to retain or consult only counsel not concurrently representing the institution or any affiliate,

(Continued)

Regulation	*Guidelines*	*Commentary*
	and whether to place limitations on any counsel representing the institution concerning matters in which such counsel previously participated personally and substantially as outside counsel to the committee.	
	36. Forming and Restructuring Audit Committees. Audit committees should be formed within four months of the effective date of this part. Some institutions may have to restructure existing audit committees to comply with this part. No regulatory action will be taken if institutions restructure their audit committees by the earlier of their next annual meeting of stockholders, or one year from the effective date of this part.	
	37. *Modifications of Guidelines*. The FDIC Board of Directors has delegated to the Director of the FDIC's Division of Supervision authority to make and publish in the *Federal Register* minor technical amendments to the Guidelines (including the attached Agreed Upon Procedures in schedule A *to* this appendix), in consultation with the other appropriate federal banking agencies, to reflect the implementation of this part. It is not anticipated any such modification would be effective until affected institutions have been given reasonable advance notice of the modification. Any material modification or amendment will be subject to review and approval of the FDIC Board of Directors.	

AGREED-UPON PROCEDURES

Reprinted in the following are the agreed-upon procedures to be performed by the independent accountant in relation to management's assertion about compliance with dividend restriction and insider loan laws and regulations. The resulting report will not be publicly available (see guideline 18). Guidance is provided in the fully italicized paragraphs.

Section I — Procedures for Individual Institutions

The following information should be obtained, and the indicated procedures should be performed, by the institution's independent public accountant in accordance with generally accepted standards for attestation engagements, or by the institution's internal auditor if the procedures set forth in section II of this schedule are to be performed by the accountant.

> ***Commentary:*** *The following sample sizes have not been objected to by the FDIC, the OCC, or the OTS for purposes of applying those procedures that require sampling:*

Population Number (N)	*Sample Size*
100 or greater	60
50 to 100	25
0 to 50	*N* or 20, whichever is smaller

A. Loans to Insiders

1. *Designated Laws.* The following laws and regulations (Designated Insider Laws) should be read:

   (a) The laws codified at 12 U.S.C. 375, 375a, 375b, 376, 1468(b), 1828(j)(2), 1828(j)(3)(B), 1817(k), and 1972; and

   (b) The regulations set forth at 12 CFR 23.5, part 31, 211.3(b)(4), part 215, 337.3, 349.3, 563.43, and 935.2.

2. *Information and Procedures.* Obtain from management of the institution, and read, the following information for the institution's most recent fiscal year through the date of the attestation report, and perform the procedures indicated with respect to such information:

   a. *General Information.* Obtain management's assessment of compliance with the Designated Insider Laws; all minutes (including minutes drafted, but not approved) of the meetings of the board and its committees; reports of examinations, supervisory agreements, and enforcement actions issued by the institution's primary federal and state regulators, if applicable; all public documents filed under the Securities and Exchange Act of 1934 with the FDIC, SEC, Federal Reserve Board, OCC, or OTS and annual reports filed by insiders identifying their related interest as required by 12 CFR 215.7.

   Procedure:

   (i) Read the foregoing information.

   (ii) Trace and agree each disclosed insider loan and other extension of credit to see that it is included on the list of Insider Transactions.

   b. *Calculations.* Obtain management's calculation of the greater of 5 percent of the institution's year-end capital and unimpaired surplus or $25,000.

Reprinted from appendix A to 12 CFR Part 363. See *Federal Register,* June 2, 1993. See footnotes 2 and * of this appendix.

Procedure: Recalculate for mathematical accuracy, and trace amounts used in management's calculations to the institution's year-end Call Report or TFR.

c. *Policies and Procedures.* Obtain the institution's written policies and procedures concerning its compliance with the Designated Insider Laws, including any written "Code of Ethics" or "Conflict of Interest" policy statements. If the institution has no written policies and procedures, obtain a narrative from management that describes the methods for complying with such laws, and includes provisions similar to those listed below.

Procedure: Ascertain that the policies and procedures include, or incorporate by reference, provisions consistent with the Designated Insider Laws for:

(i) Defining terms;

(ii) Prohibiting and restricting loans to insiders (*i.e.*, directors, executive officers, and principal shareholders and their related interests);

(iii) Maintaining records of loans to insiders;

(iv) Requiring reports and disclosures by the institution and by executive officers, directors, and principal shareholders;

(v) Disseminating policy information;

(vi) Revising policies to reflect subsequent changes in the law;

(vii) Educating employees about the legal requirements and management's related policies and procedures;

(viii) Prior approval of the board of directors or its committees, as appropriate; and

(ix) Reporting insider loans to regulatory agencies on the institution's Call Report or TFR.

d. *Insider Transactions.* Obtain a list of loans or other extensions of credit to insiders (including their related interests) during the fiscal year and management's written representations regarding —

(i) The completeness of the list, and

(ii) Whether the terms of insider transactions are comparable to those that would have been available to unaffiliated third parties.

Procedure: Select a sample of the insider transactions from the list. For each transaction in the sample selected:

(1) Ascertain that each executive officer and principal shareholder (or related interest) has reported annually to the board of directors, on or before January 31 of the following year, any indebtedness to correspondent banks, and that such report states:

(a) The maximum amount of indebtedness during the previous calendar year;

(b) The amount of indebtedness outstanding 10 days prior to report filing; and

(c) A description of the loan terms and conditions, including the rate or range of interest rates, original amount and date, maturity date, payment terms, security, and any unusual terms or conditions.

(2) *(a)* Trace and agree amounts outstanding by insiders to the schedule aggregating indebtedness of all insiders on the institution's year-end Call Report or TFR;

(b) Obtain from management documentation that indicates whether the specific extensions of credit, at the option of the institution, will become due and payable at any time that the insider is indebted to any other insured institution in an aggregate amount greater than the amount specified for a category of credit in 12 CFR 215.5(c);

(c) Obtain from management a copy of the institution's written notification to the insider to ascertain whether the insider has been informed of the reporting requirements relative to insider transactions and has acknowledged such requirements;

(d) If the credit exceeds the lesser of the calculation obtained in paragraph 2b. or $500,000, read the minutes of the meetings of the board of directors and determine whether the minutes indicate that the credit was approved in advance by the board and the insider abstained from participating directly or indirectly in voting on the transactions; and

(e) Obtain management's calculated legal lending limit for the credit and ascertain whether the amount of the credit exceeds such limit.

(3) For executive officers, directors, and principal shareholders of the institution included in the sample, obtain a written history of the insider's overdrafts for the year and obtain management's representation whether that history is complete. In addition,

(a) Inquire whether cash items for the individual are being held by the institution to prevent an overdraft, and

(b) Trace and agree subsequent payment by the insider of the insider's overdrafts to records of the account at the institution.

(4) For overdrafts of executive officers and directors included in the sample that are being paid by the institution for the executive officer and director on an account at the institution:

(a) Trace and agree to a written, pre-authorized, interest-bearing extension of credit plan that specifies a method of repayment; or,

(b) Trace and agree to a written, pre-authorized transfer of funds from another account of the insider at the institution; or,

(c) For aggregate amounts of $1,000 or less, obtain a written representation from management that:

(i) It believes the overdraft was inadvertent,

(ii) The account was overdrawn in each case for less than 5 business days, and

(iii) The institution charged the executive officer and director the same fee that it would charge any other customer in similar circumstances.

(5) For extensions of credit to an executive officer selected, ascertain that each credit was:

(a) Preceded by a submission of a financial statement;

(b) Promptly reported to the board of directors; and

(c) Made subject to the condition, as specified in the note or other evidence of indebtedness, that the extension of credit will become, at the option of the institution, due and payable at any time that the executive officer is indebted to other insured institutions in an aggregate amount greater than the executive officer would be able to borrow from the institution.

(6) Based on the types of transactions in the sample selected, select a sample of similar transactions with persons who are not insiders of the institution or its affiliates as of the same dates or within two weeks of the insider transaction. Compare the terms of the transactions with the persons not affiliated with the institution to those with insiders, and note in the findings any material differences in the terms favorable to insiders compared to the terms of the transactions with persons not affiliated with the institution or its affiliates.

> ***Commentary:*** *The independent accountant's selection of "similar" transactions and comparison of terms should only relate to objectively measurable characteristics of the loan (for example, the stated interest rate, or the type of loan).*

(7) Aggregate the indebtedness to executive officers, directors, and principal shareholders of the institution and to their related interests from the list obtained as of the end of the fiscal year and one other day selected during the year. Compare this total with 100 percent of the institution's unimpaired capital and surplus at the one day selected during the year and the end of its fiscal year. (The unimpaired capital and surplus calculated from the most recent Call Report or TFR may be used, unless there is reason to believe that a significant change has taken place between the dates.) Report any excess as an exception in the findings.

> ***Commentary:*** *The independent accountant should state his or her objective criterion for "significant change" if applicable.*

e. *Executive Officers' Reports.* Obtain a list of all written reports made by executive officers of the institution concerning debt with other insured institutions, and management's representation concerning the completeness of such list.

Procedure: Select a sample of written reports. For reports selected, note any reported aggregate extensions of credit in excess of the amounts management represents the executive officer would have been able to borrow from the reporting institution and whether the report was made within 10 days of the date the indebtedness reached such a level.

> ***Commentary:*** *The preceding procedures relate to the insider's debt at other institutions. The procedures that follow relate to the insider's debt at the covered institution.*

Obtain management's calculation of:

(i) The aggregate amount of loans and other extensions or lines of credit to the executive officer and

(ii) 2.5 percent of the institution's capital and unimpaired surplus.

Recalculate management's computations for mathematical accuracy and trace amounts used in management's computations to the institution's Call Report or TFR. Ascertain whether the aggregate amount of the credits for the executive officer exceeds the greater of 2.5 percent of the institution's capital and unimpaired surplus or $25,000, but in no event more than $100,000, unless such credits are used to finance the education of the executive officer's children or the officer's principal residence. If the credit extended is a real estate loan, obtain documentation for the credit and note whether such documentation contains representations that:

(i) The purpose of the credit is for the purchase, construction, maintenance, or improvement of the executive officer's principal residence;

(ii) The credit is secured by a first lien on the residence; and

(iii) The executive officer owns or expects to own the residence after the extension of credit.

B. Dividend Restrictions

1. *Designated Laws.* The following federal laws and regulations (Designated Dividend Laws) should be read:

(a) The laws codified at 12 U.S.C. 56, 60, 1467(a)(f), 1831o; and

(b) The regulations set forth at 12 CFR 5.61, 5.62, 6.6, 7.6120, 208.19, and 563.134.

> ***Commentary:*** *The independent accountant should also read any state laws identified by management in its assertion.*

2. *Information and Procedures.* Obtain from management of the institution, and read, the following information for the institution's most recent fiscal year through the date of the attestation report, and perform the procedures indicated with respect to such information:

a. *Management's Assessment.* Obtain management's assessment of the institution's compliance with the Designated Dividend Laws and any applicable state laws and regulations cited in management's assessment. Also obtain management's written representation whether dividends declared comply with the legal limitations and any restrictions on dividend payments under any supervisory agreements, orders, or resolution of any regulatory agency (including a description of the nature of any such agreement, order, or resolution).

b. *Policies and Procedures.* Obtain the institution's written policies and procedures concerning its compliance with the Designated Dividend Laws. If the institution has no written policies and procedures, obtain from the institution a narrative that describes the institution's methods for complying with Designated Dividend Laws, includes provisions similar to those below.

Procedure: Ascertain whether the policies and procedures include, or incorporate by reference, provisions which are consistent with the Designated Dividend Laws. For banks and savings institutions, these would include capital limitation tests, including section 38 of the FDIC Act, earnings limitation tests, transfers from surplus to undivided profits, and restrictions imposed under any supervisory agreements, resolutions, or orders of any federal or state bank regulatory agency. For savings associations, include prior notification to the OTS.

c. *Board Minutes.* Obtain minutes of the meetings of the board of directors for the most recent fiscal year to ascertain whether dividends (either paid or unpaid) have been declared.

Procedure: Trace and agree total dividend amounts to the general ledger records and the institution's appropriate Call Reports or TFRs filed with regulators.

d. *Calculation.* Obtain management's computation of the amount at which declaration of a dividend would cause the institution to be undercapitalized.

Procedure: Recalculate management's computation (for mathematical accuracy) and compare management's calculations to the amount of any dividend declared to determine whether it exceeded the amount.

e. *National and State Member Banks.* Obtain management's computation concerning its compliance with 12 U.S.C. 56, "Capital Limitation Test," 12 U.S.C. 60, "The Earnings Limitation Test," and transfers from surplus to undivided profits after payment of the dividends referenced in subsection 2c. above.

Procedure: Recalculate management's computations (for mathematical accuracy) and compare management's calculations to the standards defined in the test set forth in subsection 2d. above to ascertain whether the dividends declared fall under the permissible level under this standard. If dividends are not permissible under such standard, ascertain if the dividends were declared under approval of the appropriate federal banking agency or any other exception. If not, report the exception in the findings.

f. *Savings Associations.* Obtain management's documentation of the OTS determination of whether the institution is a Tier I, Tier II, or Tier III savings institution and management's computation of its capital ratio after declaration of dividends under the Tier determined by the OTS. For dividends declared, obtain a copy of the savings institution's notification to the OTS to ascertain whether notification was made at least 30 days before payment of any dividends.

Procedure: Recalculate management's computation (for mathematical accuracy) and trace amounts used by management in its calculation to the institution's TFRs.

Section II — Procedures for Independent Public Accountant

If the internal auditor has performed the procedures set forth in section I, the following procedures may be performed by the independent public accountant if neither the FDIC nor the appropriate federal banking agency has objected in writing. If the procedures in section I have been performed by an internal auditor employed by a holding company, such procedures should be applied to each subsidiary institution (a Covered Subsidiary) subject to this part. The report of procedures performed and list of exceptions found by the internal auditor, identifying the institution with respect to which any exception was found, should be submitted to the audit committee of the board of directors.

A. Review of Designated Laws

The Designated Insider Laws and Designated Dividend Laws applicable to the institution should be read.

B. Information and Procedures

Obtain from management of the institution, and read, the following information for the institution's most recent fiscal year through the date of the attestation report, and perform the procedures indicated with respect to such information:

1. *Designated Laws.* Read section I of this schedule. Obtain management's assessment contained in its management report on the institution's or holding company's compliance with the Designated Laws.

2. *Internal Auditor's Workpapers.* If an internal auditor performed the procedures in Section I, obtain the internal auditor's workpapers documenting the performance of those procedures on the institution, including all Covered Subsidiaries, and the chief internal auditor's written representation that:

    (a) The internal auditor or audit staff, if applicable, performed the procedures listed in section I on the institution and each Covered Subsidiary;

    (b) The internal auditor tested a sufficient number of transactions governed by the Designated Laws so that the testing was representative of the institution's or Covered Subsidiary's volume of transactions;

    (c) The workpapers accurately reflect the work performed by the internal auditor and, if applicable, the internal audit staff;

    (d) The workpapers obtained are complete; and

    (e) The internal auditor's report, which describes the procedures performed for the preceding fiscal year as well as the internal auditor's findings and exceptions noted, has been presented to the institution's audit committee.

    Procedure: Compare the workpapers to the procedures that are required to be performed under section I, and report as an exception any procedures not documented and any procedures for which the sample size is not sufficient.

Commentary: The independent accountant should compare sample sizes to those in the table on page 324. A subjective determination about the sufficiency of sample sizes is beyond the scope of an agreed-upon procedures attestation engagement.

Compare the exceptions and errors listed by the internal auditor in its report to the audit committee to those found in the workpapers, and report as an exception any exception or error found in the internal auditor's workpapers and not listed in the internal auditor's list of exceptions.

Commentary: *The objective of this procedure is to ensure that any findings identified as such by internal auditors in their workpapers are also included in their report to the institution's audit committee.*

C. Testing by Independent Public Accountant

The accountant should perform the procedures listed in section I on a representative sample of the transactions of the institution and Covered Subsidiaries to which each of the Designated Laws applies. The sample tested at each institution, or Covered Subsidiary, should be at least 20 percent of the size of the sample tested by the internal auditor at such institution, although samples selected should be from the population at large.

Commentary: *The independent accountant's sample should be selected from the population at large, not from the internal auditor's sample.*

If the testing is being performed on a holding company with more than one Covered Subsidiary, the sample tested for each Designated Law should include transactions from each such subsidiary at least every other fiscal year. If the holding company has more than eight Covered Subsidiaries, the sample of transactions tested for each Designated Law should include transactions from each such subsidiary at least every third fiscal year.

Commentary: *If, in addition to performing the Section I procedures set forth in 12 CFR Part 363, the auditor applies procedures to the internal auditor's workpapers, the following language should be provided in a separate report or included in the Section I attestation report:*

Report of Auditors on General Auditor's Assertion Relating to Internal Audit Procedures on Compliance With FDIC-Designated Safety and Soundness Laws and Regulations

To the Board of Directors
XYZ National Bank

We have performed the procedures enumerated below, which were agreed to by XYZ National Bank (the Company) and the Federal Deposit Insurance Corporation (FDIC), solely to assist them in evaluating the Company's [*title of asserter—for example, General Auditor's*] assertion, included in its representation letter dated January 31, 19X4, that: (i) the Company's Internal Audit Department (Internal Audit) performed the procedures listed in Section I of Schedule A of Appendix A to Part 363, Chapter III, Title 12, Code of Federal Regulations, on each of the Company's covered subsidiary banks over $500 million; (ii) Internal Audit tested a sufficient number of transactions governed by the laws and regulations designated under §363.2, Guidance 12, so that the testing is representative of the Company's volume of transactions; (iii) the workpapers prepared as a result of the procedures performed accurately reflect the work performed and the workpapers are complete; and (iv) a report, which describes the procedures performed and the related findings, has been presented to the Company's audit committee. The sufficiency of the procedures presented below is solely the responsibility of the specified users of the report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

Procedures and Findings

1. We compared Internal Audit's workpapers to the procedures required to be performed under Section I. We did not note any required procedures that were not documented in Internal Audit's workpapers.
2. We compared Internal Audit's sample sizes to the following criteria, to which the FDIC did not object, and found them to be in agreement:

Population Number (N)	*Sample Size*
100 or greater	60
50 to 100	25
0 to 50	*N* or 20, whichever is smaller

3. We compared errors and exceptions listed in Internal Audit's report to the Company's audit committee to those in Internal Audit's workpapers. All such errors or exceptions documented in the workpapers were included in the report.

These agreed-upon procedures are substantially less in scope than an examination, the objective of which is the expression of an opinion on the Company's General Auditor's assertions identified in the first paragraph. Accordingly, we do not express such an opinion. Additionally, we provide no assurance that the procedures described in the Internal Audit's workpapers were effectively carried out or that all error or exception conditions were identified and recorded in the working papers or communicated to the Audit Committee. Furthermore, we did not perform procedures related to the Company's [*title or asserter—for example, General Auditor's*] aforementioned assertion that the workpapers prepared as a result of the procedures accurately reflect the work performed and the workpapers are complete. Had we performed additional procedures or had we made an examination of the Company's [*title of asserter—for example, General Auditor's*] assertions identified in the first paragraph, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information of the audit committee, management, and the parties listed in the first paragraph, and should not be used by those who did not participate in determining the procedures.

D. Reports Concerning Holding Companies

Only one report of any exceptions noted from application of the procedures in section II performed by the independent public accountant on all Covered Subsidiaries of a holding company should be filed as required by guideline 3, but the report should identify, for each exception or error noted, the identity of the Covered Subsidiary to which it relates.

Appendix E
Information Sources

Further information on matters addressed in this Guide is available through various publications and services listed in the table that follows. Many non-government and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

All telephone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed for data lines.

Information Sources

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (800) TO-AICPA or (800) 862-4272 Information about AICPA continuing professional education programs is available through the AICPA CPE Division (ext. 3) and the AICPA Meetings and Travel Division: (201) 938-3232.	*24 Hour Fax Hotline* (201) 938-3787	*Accountants Forum* This information service is available on CompuServe. Some information is available only to AICPA members. To set up a CompuServe account call (800) 524-3388 and ask for the AICPA package or rep. 748.	
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10			*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
Federal Home Loan Mortgage Corporation (Freddie Mac)	*Customer Service* 8200 Jones Branch Drive McLean, VA 22102-3107 (800) FREDDIE			
Federal Deposit Insurance Corporation	*Corporate Communications* 550 17th Street, NW Washington, DC 20429-0001 (202) 416-6940	*Facsimile Bulletin Board System* (804) 642-0003	*Electronic Bulletin Board System* Instructions are available through the FDIC's Facsimile Bulletin Board System. (804) 642-2737 (d)	*Action Update* (202) 898-7210
Federal Reserve System	*Publications Services* 20th and C Streets, NW Washington, DC 20551-0001 (202) 452-3245	*U.S. Department of Commerce* *STAT-USA / FAX* Some information is available to guest users. Other information requires a subscription fee. (202) 482-0005	*U.S. Department of Commerce's Economic Bulletin Board* Some information is available to guest users. Other information requires a subscription fee. HelpLine: (202) 482-1986 (202) 482-3870 (d-300/1200/2400 bps) (202) 482-2584 (d-9600 bps) (202) 482-2167 (d-14.4 kbps) Telnet access via Internet: ebb.stat-usa.gov	*Federal Reserve Board Highlights* (202) 452-3206 *Bank Holding Company Applications and Orders* (202) 452-3207

Mortgage Bankers Association of America	*Publications Department* 1125 15th Street, NW Washington, DC 20005-2766 (800) 793-MBAA, ext. 3	*MBA Fax on Demand* This service is available only to MBA members. For more information, call (800) 793-MBAA.		
U.S. Department of the Treasury—Office of the Comptroller of the Currency	*Publications Control* P.O. Box 70004 Chicago, IL 60673-0004 (202) 874-4960	*OCC Information Line* (202) 479-0141	*U.S. Treasury's Electronic Library (TEL)* (703) 321-3339 (d) Via internet: ftp.fedworld.gov (192.239.92.205) Telnet via Internet: fedworld.gov (192.239.93.3) FTP via Internet: ftp.fedworld.gov (192.239.92.205) World Wide Web home page: http://www.fedworld.gov	
U.S. Department of the Treasury—Office of Thrift Supervision	*OTS Dissemination Branch* 1700 G Street, NW Washington, DC 20552-0001 (202) 906-6427	The OTS is developing a fax service that they may launch in late 1995.		
U.S. Department of Education	*Federal Student Aid Information Center* (800) 433-3243			
U.S. General Accounting Office	*Superintendent of Documents* U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800 (202) 512-2250 (f)		*U.S. Government Printing Office's The Federal Bulletin Board* Includes *Federal Register* notices and the Code of Federal Regulations. Users are usually expected to open a deposit account. User assistance line: (202) 512-1530 (202) 512-1387 (d) Telnet via internet: federal.bbs.gpo.gov 3001	
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 *SEC Public Reference Room* (202) 942-8079	*Information Line* (202) 942-8088, ext. 3 (202) 942-7114 (tty)	World Wide Web home page: http://=www.sec.gov	*Information Line* (202) 942-8088 (202) 942-7114 (tty)

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